The Importance of Exit Strategies in Professional Partnership Agreements

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Partnership agreements are vital for any size professional firm, large or small. Equity ownership and allocation of profits are business issues which are often addressed upon initial formation. However, one of the most important and most overlooked issues is the withdrawal of a partner or his/her retirement from the firm. The agreement should value the retiring, deceased or disabled partner's contributions to the firm, how such value is to be paid, and how such payments are characterized under the Internal Revenue Code. Agreements often fail to adequately address these issues, sometimes resulting in intense conflict and costly litigation upon the departure of a partner.

Events of withdrawal need to be clearly defined and should include voluntary withdrawal with the ability to continue to practice, involuntary withdrawal (expulsion), disability, retirement and death.

Upon withdrawal, a partner is entitled, at a minimum, to receive his/her capital account balance, his/her proportionate share of undistributed profits and his/her proportionate share of collectible accounts receivable of the partnership.

Upon a partner's withdrawal based upon death, disability or retirement, the agreement should also recognize the departing partner's prior contributions to the firm and the goodwill he/she is leaving behind. A common way to value this goodwill payment is by taking a percentage or multiple of the average compensation received by the departing partner during the three year period immediately preceding the event giving rise to such withdrawal. Such valuation could be subject to a specific year of service requirement or could vest over a period of time. Absent the availability of insurance, a large goodwill payment is not typically paid to an individual who has just become a partner. The payment terms and requisite tax characterization must also be considered. Deductibility of such payments is important absent insurance proceeds in the event of death or disability and such amount should be paid over a longer period of time to ensure the viability of the firm. The payment of the goodwill amount in the event of withdrawal based upon disability or retirement must be conditioned upon such partner being bound to a restrictive covenant.

The Internal Revenue Code allows the parties in a service partnership to control the income tax consequences of payments. The payment schedule of the foregoing, as well as the appropriate tax characterization, can be crucial to the firm's ability to make these payments and the ultimate longevity of the firm. The deductibility of such payments in the year they are paid could be the difference between the firm being able to make such payments to the withdrawing partner (or his/her estate) or ceasing operations because the remaining partners cannot draw enough income to earn a living.

The agreement also needs to provide the departing partner with the comfort that the amounts due him/her by the firm will be paid. Such payout should be guaranteed by the remaining partners subject to their own death, disability or retirement. Additional safeguards should be included to ensure that the remaining partners do not dissolve the firm or voluntarily withdraw to avoid paying the withdrawing partner while utilizing a new entity to enjoy the benefits of the goodwill left behind by the senior partner.

Partners should review their partnership agreement to ensure that all withdrawal issues are adequately covered and that the agreement reflects present realities and the current intentions of the parties. The time spent doing so will be well worth the benefits of a smooth transition and the avoidance of ill will, unnecessary disputes and possible costly litigation.

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