

INVESTING IN PEOPLE

by Alan N. Walter

These are mere business relations ...; there is no friendship in them, no particular interest, nothing like sentiment Charles Dickens, *A Tale of Two Cities*

In spite of the recession, this may be the time to form new relationships, to bring in that new person and expand your business.

The financial markets are in crisis. Assets under management have fallen and asset management firms are failing. What's an advisor to do? Invest with wisdom ...in people. (And buy low, of course.)

Declining AUM can mean declining valuations of investment advisory firms, declining fees and the inability of certain advisors and representatives to make it on their own. This may be the perfect opportunity to acquire another firm or pick up a new representative or two, to create new internal business relations.

I am hopeful that Mr. Dickens is wrong, that the new relations will be "mere" business relations without friendship or sentiment. But still, it pays to prepare for the worst and hope it never comes to pass.

This article concentrates on the commercial issues to consider when bringing on a new partner or representative. It does not address any regulatory considerations that may arise.

What Role?

There are basically three different ways a new person can be brought on: as an employee, independent contractor or an equity holder. (For ease of reference, I will refer to equity holders as partners. The issues in this article, however, will apply equally to the shareholders of a corporation and the members of a limited liability company.)

Employee And Contractor

Any person giving advice to your clients, who is not an owner of the firm, will be deemed to be an employee for regulatory purposes. However, this will not be the case for tax purposes.

Treatises have been written on the differences between employees and independent contractors. I won't attempt to summarize them here. But simply put, employees receive W-2s at the end of the year; independent contractors, 1099s.

Employee's wages are generally subject to Social Security and unemployment taxes and income-tax withholding; this is not true of the payments made to independent contractors. So, there are clear financial advantages for a firm to classify a person as an independent contractor.

Unfortunately, the firm cannot simply decide how to classify a person. In the end, the IRS gets to make this determination.

The IRS will focus primarily on control: the degree to which the firm has the right or ability to control and direct the person. The greater the control that the firm exercises over the person, the greater the possibility that the IRS will consider the person to be an employee. If the person is required to perform her services at the time and place set by the firm, using the “tools” of the firm, she is more likely than not an employee. If, instead, the person is free to choose her own work hours and location, and is paid on a unit basis, rather than on an hourly or annual basis, the person is probably an independent contractor.

Considerations

If the new person will be in direct contact with clients, make sure that you enter into an agreement. This is advisable whether the person is an employee or independent contractor. The agreement should contain certain key provisions.

First, it should set forth the basic compensation terms. Will the person be paid a salary or a percentage of fees collected or both?

Second, the agreement should contain at least basic non-disclosure provisions. The new person must agree to safeguard the confidentiality of information about your clients and your business practices.

Third, the agreement should provide that the new person will not solicit your clients. This covenant not to solicit should be customized for your individual situation.

Fourth, the agreement should clearly set forth what will happen should you and the new person desire or need to part ways. Should there be notice of the split? Who does each client “belong” to? Will compensation continue after the separation?

How About Partners?

Partnerships are like marriages—relatively easy to enter into, but painful to dissolve. For this reason, I generally advise that future partners have a trial period before they actually “partner up.” Cohabitation before marriage, so to speak.

Hire a new person as a representative first. Or, if the new person has the potential to become your more-or-less equal partner, or objects to being characterized as a representative, consider entering into a limited joint venture and sharing space. In either case, use the opportunity to evaluate each other.

It is helpful to memorialize the arrangement in writing. As discussed above, at the least, it should be absolutely clear to each of you—and to a judge should you unfortunately end up in court—how fees will be split and clients will be handled, during and after the trial period.

The financial aspects of a partnership can sometimes be the easiest part of the arrangement. Its success or failure will more likely turn on other issues, such as whether you have similar lifestyles, values and work ethic. The trial period is the perfect opportunity to really discover this.

The Agreement

If you make it through the trial period and still want to associate with each other, it's time to enter into a definitive partnership agreement (or shareholders or operating agreement). Enter into the agreement sooner rather than later. The worst scenario is to wait until you have disagreements—then, it may be too late.

The agreement can cover many areas, but at a minimum, it should address the following:

- **Management.** Will the firm be managed by one or more individuals? By a board of managers? How much power will the managers have?
- **Voting.** Who gets to vote on what issues? Will this differ depending on whether the decisions to be made are major or minor? For that matter, what are major and minor decisions?
- **Distribution.** Will profits and cash flow be distributed in accordance with the equity ownership? Will certain income streams be directed to certain individuals? Will anyone get preferential distributions?
- **Transfer restrictions.** Can each person freely transfer his or her partnership interest? When will a person accepting a transfer of the interest be accepted as a partner?
- **Buy/sell provisions.** What will happen if a partner dies or becomes disabled? Or simply wants to walk?

Do not buy an agreement off the shelf or from a document production company. You must make sure that the agreement properly reflects your concerns and is properly drafted to reflect your deal. You will be living with it for a long, long time.

Conclusion

Bring in a new person, but do it right. You want to make sure that this step—which may very well be a major one—is done correctly. It is far easier to do it right initially than to try to correct any problems later.

This may be the time to form new relationships, to bring in that new person and expand your business.

Hard times can create real opportunities.

... it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us Charles Dickens, *A Tale of Two Cities*

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