BCG ATTORNEY SEARCH

Retiring Partners and Unfunded Law Firm Commitments

The issues surrounding retiring partners and compensation have created problems for many law firms. While not universally true, unfunded retirement plans, whether tied to some average of historical income or to receipts associated with continuing client fees from the partner's responsible clients, are generally without economic justification and usually a serious economic problem.

Most law firms simply cannot afford to continue paying partners beyond their working lives. And there is no reason a partner in a law firm cannot accumulate a significant funded retirement plan through a combination of the various available qualified plan vehicles. There are few destitute partners retiring from law firms anymore.

More important, the logical underpinnings for unfunded plans have largely evaporated in most firms. There is clearly no need for the plans to provide retirement income, although older partners in firms with such plans often consider them in their own planning (often encouraging productive partners to retire earlier than the firm would prefer.) Likewise, there is no systematic or convincing anecdotal evidence to suggest that such plans provide "golden handcuffs" that keep important lawyers in their firms. Although relatively fewer senior lawyers--i.e., those closer to retirement--move than younger lawyers, this is clearly the case in firms without plans, as well as in those with them.

On the other hand, there is substantial evidence indicating that valuable lawyers move away from firms with such plans to avoid funding retirement benefits for partners to whom they feel no obligation. Finally, there is little evidence that such plans, even ones specifically tied to client retention, increase the likelihood of client retention. This rather important goal is best facilitated through appropriate planning and compensation approaches during the partner's last years before retirement, rather than afterward.

While there are few positive reasons for maintaining the plans in most firms, there are enough problems created by them to suggest that cutting them back or eliminating them would improve the long-term outlook for the firm. First, plans are a drag on the economic performance of the firm. If the firm is at the top of its market in terms of economic performance, it may be able to handle some level of unfunded retirement benefits. However, for most firms, the effect of the plan is to reduce the income paid to the partner to below his or her market value, which contributes to the attrition of valuable partners, usually in the prime growth period of their careers.

Second, significant unfunded obligations can create serious differences in the personal interests of the partners, often along generational lines. Such conflicts can rise to the level of a serious problem in some firms.

Finally, unfunded retirement plans can be a problem in lateral recruiting and are often a serious issue in law firm mergers.

With little foundation and significant potential problems, it is clear that for most law firms, unfunded retirement plans are a problematic anachronism. This has generated a clear trend toward "doing something about" unfunded plans in many firms. But, assuming a firm has a problem, what can be done?

Ending Unfunded Retirement Plans

Once the firm decides to do something, there are a number of approaches available to eliminate the problem associated with the unfunded retirement plan. Perhaps the most obvious approach is to simply fund the plan; however, this is not as easy as it looks.

During the early to mid-1980's, a number of law firms attempted to fund their retirement obligations, generally through life insurance vehicles. Not surprisingly, this rarely, if ever, worked. Today, funding approaches are available that offer at least the prospect of successfully funding the plans, assuming the stock market cooperates. However, these approaches have not been well established, nor do they have a significant track record of success.

Of course, there is a real cost of funding the plan. Significantly, changes in the tax rules have created opportunities for firms in a position to invest beyond the traditional limits of qualified savings vehicles to create supplemental benefit programs on a tax-and creditor-advantaged basis. So, those firms who wish to do more advance funding may be better off simply abandoning their plans in favor of additional qualified retirement plan benefits.

A much more common approach to dealing with problematic retirement plans is to eliminate them in some orderly fashion. There are three basic approaches to eliminating unfunded retirement plans. These include:
"Cold Turkey" Elimination of the Plan. This is the least common approach in practice; however, a few firms have succeeded in simply voting out the benefit for all partners, effective immediately. For obvious reasons, this requires either favorable internal political circumstances or strong leadership, or both. It also helps if the partnership is relatively young at the time when the decision is made.
Phase-outs. Many firms have phased out their retirement plans. The most common approach to this involves those closest to retirement receiving the largest share of their expected retirement benefits, with those farther away receiving less. At some stage, say age 50 and below, partners would no longer receive these benefits. This approach works, but often has the effect of keeping a residual plan around for a long time, which may create some internal problems and will not quickly help in the context of merger.
Buy-outs. A number of firms have been able to buy out their retirement obligations by devoting a share of the firms' current incomes for a limited number of years to satisfying the obligations for future benefits. While this has some political challenges and increases the costs in the short term, it is often the most effective way to quickly deal with a substantial obligation.
Through using one or a combination of these three approaches, a firm can successfully eliminate a significant and problematic obligation with a limited amount of pain.

Preretirement Partner Compensation: What Makes Sense?

Many unfunded retirement plans pay retired partners a portion of the revenue received from "their" clients after retirement, on the theory that this would encourage them to try to keep the client with the firm. But there is little evidence that firms with such retirement plans have better retention of clients after the partner's retirement than those firms without them.

Far more important to the retention of clients after a partner's retirement is his or her actions and efforts in the time leading up to retirement. Simply put, those partners who make significant efforts to institutionalize (or at least transfer) during the three to five years prior to retirement are more likely to keep their clients with the firm than those who do not. However, most firms pay little attention, formal or otherwise, to the partners' efforts to plan for retirement. In fact, many actively discourage partners from transitioning clients by keeping the partners subject to a retirement approach that forces them to maintain client "control" and continue to bill significant hours.

A better approach for both the partner and the firm is to begin focusing on the partner's desire to slow down and retire several years before his actual target date. Typically, it will take three to five years to fully transition a significant legal practice. Therefore, at least a few years before the partner's intended retirement (or the firm's mandatory retirement age), the firm and the partner should agree on a plan for transition.

During this time, the firm should focus on different agreed criteria, rather than the firm's normal compensation criteria, in setting compensation. In large part, the partner should be compensated to work toward transitioning his client base while still continuing to bill a reasonable, but lower, number of hours and continuing to find new clients. During this period, the partner should never be marketing alone and should be rewarded for his or her efforts to introduce and incorporate other lawyers into the client relationship. Properly done, the firm will have paid him or her to transition his or her client base in advance of retirement.

There are, of course, other approaches to accommodating lawyers who want to slow down but still contribute to the marketing and practice of the firm. Many firms craft "of counsel" positions to accommodate the specific needs of the individual and the firm. If the position is properly constructed, there is no reason why a mutually beneficial arrangement cannot be maintained as long as the partner wants and is capable of remaining productive.

Economic issues surrounding the retirement of partners are frequently troubling to law firms, and are generally made worse by their reluctance to address the issues in a timely manner. Nevertheless, with careful management and aggressive leadership, there is no reason that partners' retirements cannot be a vehicle for strengthening the firm.