Altman Weil, Inc.

Report to Legal Management

November 2003
Volume 31, Number 2

OUR 30TH YEAR

Retirement Basics: For the Law Firm


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Law firms, like all organizations, must deal with the issue of retirement — the final phase in an individual's work life. There are the normal issues of providing the financial assets from which to pay retirement benefits, but there are also issues of succession, transition, management, leadership, and clients. These issues are significant. They don't go away or resolve themselves if ignored. Furthermore, delay limits the range of solutions and their affordability.

The intent of this article is to provide an overview of these issues, encourage further reading on the topic, and stimulate an educational process for all. The material is derived from data compiled by Altman Weil, Inc. over the years from its surveys of the profession regarding retirement and withdrawal, and from the author's consulting experience.

Formal Policies

Not every law firm has a formal, documented program regarding retirement that includes compensation, timing, transition, succession, management, clients and the like. The larger the firm, the more likely that it has dealt with these issues in some manner. The benefit of working through these issues now is that you can do so before the retirements that will cascade through the legal profession over the next 30 years. By 2018, the youngest Baby Boomers will be in their mid-fifties and the oldest will be in their early 70s. Taking steps to plan for these changes now allows a firm to undertake a more thoughtful assessment of its needs and avoid the uncomfortable situation of last minute, *ad hoc*, individual negotiations.

Senior partners are concerned about receiving some financial recognition for what they have built, and preferably, some certainty in the deal. Be mindful that younger partners and clients are concerned about these issues as well. Clients want to know who will be in charge of their legal matters. If they see little underway for a transition, they may seek to reduce their risk by bringing in alternate counsel. Younger partners want to know that leadership and management succession have been considered and that individuals from their ranks are being groomed for these important roles. Younger partners are also concerned about the retirement financial obligations they will be expected to shoulder. And the clients' concerns are not lost on younger partners as they view the current client relationships as critical for the firm's future prosperity.

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Developing leadership and management skills in people takes time and effort. One Fortune 50 company takes a decade or more to groom its future CEO. It is the expressed view of that company that this grooming process is one of the most important functions of the current CEO.

Retirement Age

Retirement in the legal profession is not too different from retirement in other industries. Early retirement generally occurs between ages 55 (slightly earlier than the nation as a whole) and 62. Normal retirement remains at 65, the historical retirement age under Social Security. Mandatory retirement is generally between ages 67 and 75, with 70 as the majority choice. Interestingly, just under 50 percent of law firms *explicitly* deal with this issue of retirement age.

Benefits to Retired Owners

As the Baby Boom generation marches towards retirement, the topic of post-employment benefits takes on greater importance. Over half of law firms surveyed provide post-retirement health insurance. Over two-thirds provide office and staff support and just over one-quarter provide life insurance. In an era of increasing concern over the rising costs of operating a law firm, it seems that taking care of retired members of the firm is still regarded as the "right" thing to do.

Return of Capital

The return of capital in law firms (repurchase of stock in professional corporations) is, for most firms, a minor amount. Less than 10 percent of the firms surveyed indicated that they use the accrual method of valuing capital. Accordingly, the return of capital ranges from a few thousand to a few hundred thousand dollars spread over six to 60 months. This represents two surprising changes from earlier studies: first, that the lower quartile value for the term of which capital is returned went from one year to six months; and, second, that the upper quartile value went from three to five years. The latter probably reflects the increasing number of retirees coupled with the increasing level of capital in many law firms. Unbilled time and accounts receivable generally remain with the law firm. Goodwill is generally not valued. (Given that clients typically hire lawyers and not law firms,that is appropriate.)

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Qualified Retirement Plans

Retirement plans qualified by the Internal Revenue Service (IRS-qualified plans) are practically universal among law firms. In recent years more and more smaller law firms have moved to take greater advantage of these programs.

Professional corporations were created primarily for the tax advantages and the limited liability that come with the corporate form of organization. Until 1982, qualified retirement planning for corporations and partnerships had substantial differences. Then, in 1982, the Tax Equity and Fiscal Responsibility Act (TEFRA) eliminated those differences. This allowed significant increases in benefits for proprietorships, partnerships, and S corporations. This was a key event that would reshape the retirement philosophy of firms during the remaining years of the 20th Century.

Such funded retirement programs — where the availability of retirement assets is assured by setting aside current income as it is earned and before the payment of personal income taxes — had been an absolute winner for many law firms through the mid-1980s. High tax rates and more liberal deferral and exclusion rules made it possible for law firm owners to save more in taxes than contributions for non-owners cost.

The 1986 Tax Act made the decision more difficult, as the changes in tax and pension laws made it more expensive to maintain such plans. The underlying benefit of tax deferral and forced savings in a protected trust, however, continued. Those attributes still represent the single best means to accumulate capital for one's later years of life.

Qualified plans are highly regulated under IRS and U.S. Labor Department rules. These plans provide for preferential tax treatment of contributions (immediate deduction) and benefits (tax deferral and special treatment at distribution) in exchange for broad coverage and nondiscrimination provisions. Plan earnings accumulate tax-free, and plan assets must be secured (placed outside the reach of the employer and creditors) in a trust for such purpose.

The drawbacks of qualified plans are reporting, disclosure, and other regulatory considerations. Unfortunately, the plans also have severe restrictions on annual

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contributions and benefits. They are typically expensive to administer, particularly defined-benefit plans, which require the services of actuaries and payment of pension benefit insurance premiums. Also to be considered is the cost of covering non-lawyer employees of the firm. The current coverage and nondiscrimination rules protect employees who are not highly compensated, and prohibit the one-employee professional corporation plans formerly available.

Non-qualified Plans

As their name implies, non-qualified plans do not qualify for preferential tax treatment under the tax laws (no immediate deduction or tax deferral). Earnings can accumulate tax-free only if a life insurance funding vehicle is used. They also lack the asset security that qualified plans may provide.

On the other hand, the plans are unhindered by the coverage and nondiscrimination regulations that affect qualified plans. A firm may discriminate, deciding the amount of benefits it is willing to accrue, and for whom. These plans, however, must be limited to highly compensated and key management employees. Such programs do not carry the reporting and disclosure burdens of qualified plans (a simple one-time disclosure filing with the U.S. Department of Labor is required).

The lack of preferential tax treatment (deduction for the employer's contribution must be taken in the same year that the employee recognizes the income) means that it is expensive to fund such plans — as a result they are usually unfunded. Two general funding vehicles exist when the tax cost of funding is not an issue and segregation of the assets is. Rabbi trusts secure the assets for deferred compensation for solvent employers, but not from creditors of insolvent employers. Secular trusts are used when the assets are to be secured from employers' creditors as well. Secular trusts require greater funding than rabbi trusts, because employees must pay taxes on contributions to secular trusts (but not on contributions to rabbi trusts). These funding techniques are common in many corporations, but not in law firms.

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Unfunded Obligations

Traditional unfunded obligations represent a fundamental risk to the legal profession in an era of partner mobility, limited ability to maintain or expand leverage, an aging lawyer population, pricing (cost) constraints from clients, and a very competitive labor market. The history of unfunded obligations goes back to an era before professional corporations, before qualified retirement plans, before ERISA, and, in some cases, before Social Security old-age benefits. It was an era of relatively easy profits and rapid growth for both lawyers and legal business. Ownership structures were stable. The proportion of the profession benefiting from these obligations was small when compared with the proportion providing the profits from which the benefits were paid.

Unfunded entitlements, which rely on the ability and willingness of future owners to pay the benefits set forth in such plans, continue with some surprising popularity. A little more than 25 percent of law firms maintain such plans. However, the prevalence of these plans has been declining since the late 1980s. And many of the remaining plans have been modified with payment caps, reduced benefit formulas, longer vesting requirements, and other strategies to limit or reduce the future economic impact on the firm.

Today, firms are far more interested in sustainability, succession and their future viability than they are in looking back over a partner's well-paid career and saying "Let's give him / her some more." If future profits are going to be paid to retired partners, the firm sees the *quid pro quo* as securing future revenue sources in clients and referral sources. Recognizing past service of a partner, except for founders, is just not of prime importance in law firms. A program looking forward, based on the principles that client and business relationships are being effectively transitioned can provide recognition for those efforts.

Such a program may focus on the core clients and business of the firm. Management must make smart decisions regarding what work they seek to preserve. Also, and this cannot be stressed too much, management must be actively and visibly involved in this endeavor. Senior partners, rising younger partners who will be your future stars, and key clients are involved. The managing partner is the person who has the stature and position to guide this process and demonstrate the appropriate level of interest to the clients. Remember, the clients are asking themselves, "If not you, then who is going to do my work when you are gone?"

This type of program is probably best handled with great latitude so that transition may vary by lawyer and by client. Much will depend on how important it is that the senior partner does the work with regard to keeping the relationship strong. Those clients and practices for whom this is important are going to offer the most significant challenges to transition efforts.

Payments and terms of payment will vary. But general ranges of 5% to 20% of fees transitioned over two to five years are certainly broad parameters that should work. Some firms may tier or gradually reduce the percentage to the senior partner, while concurrently ramping up the recognition to the successors. Some programs will reward all future fees, even growth, during the transition period. Others will not.

One note of caution: the unintended consequence of this approach is the danger of hoarding clients. This sort of behavior is not what most firms want in their partners. How this plays out will largely be a consequence of the strength of the firm's culture and values. Will such behavior be accepted within the firm? If it is, then a program as outlined above may not serve the firm well. However, if client sharing is a strong attribute within the firm, the program above may very well make a fine supporting addition to a firm's transition efforts.

The Legal Profession

The legal profession faces the same demographic issues as the nation generally, and accordingly, its pay-as-you-go system faces challenges similar to the Social Security system. The Labor Department states that one in eight Americans was over age 65 in 1994 and that will increase to one in five by 2050. Further, it states that today's adults have an average life expectancy of 17 additional years after reaching age 65. And women will generally live longer than men. Income falls in retirement, generally considerably faster and farther than outlays.

The profession is aging and living longer. Partners are realizing the changes that retirement will bring economically and many are resisting the transition or are looking to spread the adjustment over several years of reducing income and work. More women are rising through the ranks — at 24 percent of the legal profession in 1995, women could represent 38 percent in another 20 years. The change in the gender mix is particularly important given the statistics on longer life spans for women. There are also indications that the traditional "die with your boots on" ethic is waning.

Moreover, law firms are experiencing burgeoning independence in the lawyer ranks. Both associates and partners are "jumping ship" with increasing frequency. The legal market is extremely competitive, and Model Rule 5.6 of the Model Rules of Professional Conduct (formerly DR 2-108) effectively allows partners and shareholders in law firms to change firms and take their clients with them whenever they choose to do so. As a result, partners or shareholders with books of business that would entitle them to greater compensation elsewhere frequently leave their firms. Often the most productive partners or shareholders defect, along with their revenue streams, which places their previous firms in severe jeopardy. Left behind in many cases are the liabilities for debt and office space that now must be shared by a smaller group. This is not an environment in which one should entrustone's successors with one's financial retirement entitlements.

Indeed, law firms continue to grapple with past promises and their future economic impact. The answers are not easy, emotions are heightened, and the dollars are not insignificant. But law firms do need to deal with the issue, because unfunded retirement/buy-out plans represent a clear competitive disadvantage in the marketplace. Firms seeking senior lateral hires or merger partners have a tough time if the fiscal house is not in order. Good mergers have not happened and attractive lateral candidates have gone elsewhere because of unfunded plans. In a market where finding and keeping the right people is fundamental to the competitive position of the organization, such a disadvantage is unwise. ◆

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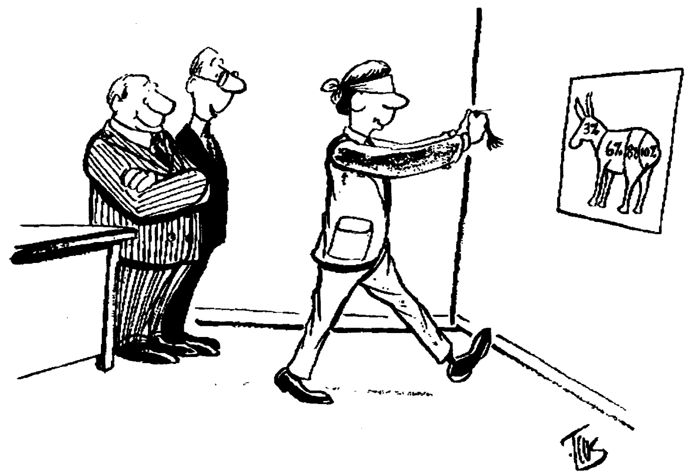

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