



Ward Bower

# Retiring Unfunded Obligations

By Ward Bower

**U**nfunded obligations are off-balance sheet liabilities to departed partners secured by contract. In professional corporations they generally take the form of deferred compensation so they are deductible to the firm.

## Rationale

Unfunded obligations (UOs) are created for a variety of reasons:

- To reward founders and early partners for the entrepreneurial risk and investment in starting and growing the firm.
- To reward departing partners for the value of WIP and AR left with the firm (offset by working capital initially required until the lawyer became economically viable when joining the firm).
- To provide a source of income in retirement, especially in the era before tax deferred retirement funding schemes became available, with time to build a meaningful retirement fund.
- To give retiring partners reason to help ensure the ongoing success and survival of the firm after their departure.

Altman Weil survey data shows that fewer firms today have such arrangements than five or ten years ago, fewer than even three years ago. About 28% of firms participating in Altman Weil's 2002 survey have such an arrangement. UOs are quantified in a number of ways: based on AR and WIP at date of retirement, compensation points, final average earnings formulae, or ongoing revenues from the partner's clients after retirement.

## Impact on the Firm

The move to reduce or eliminate UOs comes from the economic burden on the "surviving" partners, as UOs are paid from then-current earnings of the firm, reducing partner incomes. UOs have caused some firms to dissolve rather than carry this burden.

They also make merger difficult where the other firm does not have such an obligation.

Firms with a UO seek to reduce the one-year impact of the UO by "capping" the amount of UO payments in any given year to a percentage of either gross fee revenues (typically one to two percent) or net income (typically three to six percent). The delicate balancing act is to establish a UO which is bearable by the firm so its receipt is reasonably assured to the departed partner—i.e., not so burdensome as to cause partners to withdraw or the firm to collapse.

## Reducing/Eliminating the UO

Many firms in recent years have reduced or eliminated altogether the UO. Generally that requires sacrifice on the part of individual partners who may view the UO as a contractual obligation on which they are relying as part of their retirement income. This issue is more sensitive the more senior the partner, so it is always best to address it sooner rather than later.

## Reduction/Elimination of the UO

Law firms in recent years have employed many schemes to reduce or eliminate the UO. They include:

- Use of life insurance with cash values applied to offset the UO, or to reimburse the firm for the UO previously paid to the partner on death, or to transfer to the retiree in place of his or her UO.
- Use of annuities to fund the projected UO, even though the premiums are not deductible.
- Use of "rabbi trusts" as a funding vehicle.
- Considering "excess profits" (e.g., partner incomes in excess of 120% of prior year incomes, for example) as offsets against UOs ultimately due.
- Offsetting UOs by firm contributions (or a percentage of them) to tax-deferred retirement plans (401k's, defined contribution plans, etc.), even though it is arguably the

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partner's "own money" used for such a purpose.

- "Grandfathering" more senior partners and cutting off the UO entirely for more junior partners (easier where there is an age gap).
- Diminishing the benefit over time—e.g. 100% of UO to partners retiring in the next two years, 75% in two to five years, 50% in five to ten years, etc.

The method selected will depend on the specific circumstances of the firm—burden, amounts involved, economics, demographics, sources of tax-deferred retirement funds, etc. The key to reducing this burden is to obtain universal understanding of the issue and reasonable concessions by partners for the long term good of the firm, or even for its survival. In recent years some firms have chosen to recast their UO as a deciding

percentage of fees received from clients of the retired partner, providing an incentive for partners to transition their client relationships so that clients remain with the firm. ♦

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