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Retirement Benefits – Does your Firm Provide a Nest Egg?

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For many years, a generation of law firm partners has become accustomed to funding their own retirements through personal savings and schemes. They know that their naked-in-naked-out style of partnership means they will never be able to extract value from their years of effort. However, partners in highly profitable first-generation law firms – those they have founded in the last thirty years or so – are waking up to the realization that the legacy they have built up has some value that does not necessarily need to be given away. They are therefore becoming increasingly reluctant to envisage free entry (other than fixed-capital contribution) to the firm by new partners with no benefit to those who built the firm. After all, new partners come into a firm which enjoys the benefits of an established brand, a sustainable client base, and a successful business recipe – all painstakingly developed by the hard work and skill of the founding partners.

Historically, goodwill started to be excluded from accounts of law firm partnerships in the 1960s and 1970s. Existing partners were often at that time compensated for goodwill write-out by being given an annuity – sometimes for life – to reflect the fact that they had not had an opportunity to build up a pension. According to one report for example, after 15 years of partnership at Clifford Chance, retiring partners were allowed to receive an annuity of 17% of their final profit share for five years, rising to 23% for partners with more than twenty years of service. The annuity solution has remained in place for a few law firms and accountancy firms, with different arrangements in place for valuing the annuity by reference to the average of the last five years compensation or on an agreed multiple of the firm's underlying profitability, and payable over a five- or ten-year period.

As a possible alternative, some firms are considering asking new partners to buy their partnership share on an agreed valuation methodology. Valuations of any law firm as a going concern is notoriously difficult, particularly in jurisdictions such as the USA and Canada where law firms are not freely marketable outside the established legal profession. Some firms – especially those burdened with debt – are worth little or nothing, but at the other extreme we often see firms that are so profitable and valuable that any market valuation of an incoming partner's share becomes an unaffordable proposition.

The annuity option is therefore possibly more viable. However, to take this forward, founding partners who want to reserve retirement benefits for themselves need to answer three questions:

1. Is their firm worth anything now or likely to be worth anything when they leave?
2. More specifically, is their firm sufficiently attractive to new partners if the entry deal was to include retirement provisions for the founding partners?
3. If satisfied about their answers to the first two questions, what provisions are likely to provide fair protection for the retiring founder partners whilst remaining affordable for the continuing partnership?

Whilst the founding partners will presumably continue to derive income benefits from their shares of an increasingly profitable business, a balance needs to be struck between – on the one hand –encouraging and rewarding talented new lawyers, and – on the other hand – compensating the founding partners for their heavy investments over time.