News | LAW FIRMS

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Succession Planning: Is Your Firm Prepared?

With the partner-client relationship at the core of every engagement, client retention in light of a partner retirement is paramount to the sustainability and financial security of the business. Yet multi-owner firms need to have a plan in effect as part of the firm's operations, versus reacting to a specific event or departing partner.

Certainly, the need for accommodating special situations will arise, however, a succession plan helps protect a firm's equity partners and the firm at-large. Establishing a formal succession plan also communicates to partners, professionals, and support personnel that the firm will continue post-retirement of its Baby Boomers. Even firms that have succession plans in place can benefit from updating or formalizing those plans, given current market conditions.

Getting Started

Firms should consider establishing an internal committee dedicated to developing the succession plan, possibly with the help of a third-party facilitator. Some firms may also choose to have a partner retreat to address the issue.

To determine a target retirement age, a good starting point may be talking to senior partners about their "game plans" when it comes to retirement. While this will help gather a consensus on what the firm's partners have in mind for a retirement age, on average the set retirement age used by many firms is between age 65 and 70. With that being said, the American Bar Association recommends, "flexibility and consideration to the needs of the firm and the individual partner."

For firms with partners that operate as individual practitioners, essentially silos under one roof, the firm needs to change its vision *before* being capable of realizing any progress with succession planning. The culture needs to be one in which everyone, from the top down, embraces the "one firm" concept and shares in the goal of success and financial stability for the firm, and thus its partners and professionals.

Managing the Transition

Successful transition planning requires the buy-in of the retiring partner. In some cases, this may initially be a challenge, as vanity and egos come into play and partners may refuse to acknowledge that they are getting older or that a successor will succeed as they have in maintaining positive client relationships. Giving the retiring partners a say in their successors and an equitable compensation plan can help dissuade concerns and assist in smoothing out the process.

Just as it took time to build the relationship with the client, the transition will also happen over the course of three to five years through the implementation of a "phased retirement model." The exact timeline is dependent on the needs of the firm, but each firm should follow these core steps in a phased retirement model:

- **Identify the transition partner who will handle client responsibilities.** In deciding who the transition partner might be, assemble a list of possible partners, who the firm, together with the retiring partner, decides might be best suited to take over the attorney-client relationship. Expertise and practice area knowledge are critical, but personal factors, such as personality, temperament, and even hobbies and interests, play a major role in the success of an attorney-client relationship. If the partner with the right technical expertise isn't a good fit for the client in terms of personality and interest, consider having two partners team up to take over the client—one to manage the relationship and one to perform the legal work.

The goal is to select a transition partner or partners who both the firm and the retiring partner feel will have the best chance of success in keeping the client with the firm. Clients remain clients of the firms for the delivery of an expected high level of service.

- **Create a compensation agreement.** Both the firm and the retiring partner have a vested interest in this process and creating a financial formula that fairly compensates the departing partner for his or her efforts is one of the key components of a winning succession plan. Part of the transition process is also transferring billing responsibilities to the new servicing partner. Since many firms determine compensation packages through billing and collections, it is critically important not to penalize the departing partner in this factor of the compensation model. Consider a sliding scale with decreases in compensation as the workflow decreases. Most importantly, clearly define a compensation agreement for the transition period at the beginning of the transition.

  The firm's accountants or a firm that has experience in law firm compensation models can provide valuable input in overcoming this potential hurdle.

- **Encourage a process that best serves the needs of the client.** From the outset, both the firm and the retiring partner need to tailor their succession plan to preserve the attorney-client relationship, which is fundamental to the financial security of the firm. Upon selection of a transition partner to serve an existing client, it is in the best interest of the firm to encourage working together to preserve the client's confidence that the succession or transition partner will devote their attention and expertise to their needs. During this "passing of the baton," the retiring partner should dedicate his or her efforts to mentoring the succession partner in the finer nuances of the attorney-client relationship. This is critical in developing good chemistry with the client so as to encourage the client to remain with the firm.

- **Control the process at the firm level.** To help ensure that all partners involved in the transition process work together for the good of the firm, the management or executive committee needs to control the process. If the retiring partner begins the transition process knowing that there is a clear roadmap for the process and the firm will compensate him or her fairly, the process is smoother for everyone. In addition, with professionals trending toward working longer in their careers, firms need to understand the timeline of retirement for these rainmakers.

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Completing the Transition

As the retiring partner begins to transition out of the client relationship, he or she needs to honestly evaluate how the new relationship is working. Are the new partner(s) and the client getting along? Is there mutual respect? Are the legal matters progressing as they should be? For the first several months, the retiring partner should periodically check in with both the partner and the client, separately, to see how things are going. If things are going well, the transitioning partner should slowly phase out the calls to fully transition the relationship management to the new partner(s).

If things are not going well, the firm needs to assess whether the relationship can be improved or if it would be better to transition the client to a different partner. It's important to keep in mind that it takes time to build up a client's comfort level, so one shouldn't give up on the new partner just because of a few small glitches. On the other hand, if there are issues that will likely be difficult to resolve—such as a personality conflict—then it is better to be proactive and change the partner assignment than to let the relationship languish, ultimately costing the firm the client.

Firms can also consider maintaining a working relationship, such as a consulting arrangement, with the partner post-retirement. The firm benefits from the partner's expertise while the partner may enjoy staying engaged in the profession.

In Summary

The best succession plans are integrated in the firm's business plan and overall strategy. The plan should be formalized by the firm and clearly outlined and communicated to the partners and professionals, who will hopefully someday be the future of the firm. Younger professionals who invest their developmental years with a firm should know that such policies are in place and realize that the firm has taken steps to keep it financially sound in the years to come.

Perhaps, the first step may be a call to your accounting firm to help build a roadmap for succession planning. Like law firms, they are in the professional services business and face similar succession issues, and your accounting firm understands your firm's culture and financial position. ■

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Alternative Fee Arrangements: Yesterday and Today

Alternative fee arrangements ("AFAs") are not new to the law firm industry, but they have gained traction in recent years. While AFAs have long been a response to clients' demands to lower fees, today, law firms are increasingly taking a proactive approach and offering alternatives to the hourly billing system upfront. These law firms have realized that it may be prudent to do so in order to help maintain a client relationship and gain a competitive advantage.

According to legal consulting firm Altman Weil's 2011 *Law Firms in Transition Survey*, AFAs are used by 95 percent of all law firms and by 100 percent of firms with 250 or more lawyers. Yet, the study continues to cite that despite the prevalence and growth of AFAs, only 12 percent of firms reported that non-hourly projects are more profitable than hourly billing. An additional 37 percent reported them to be about as profitable as projects billed on an hourly basis.

In our experience, we have found that the most successful law firms keep the following in mind when in it comes to AFAs:

1. **Client perception is reality.** Regardless of the reason you may propose an AFA, the most important consideration is the client's perception. The value of the legal services from the client's perception is that the benefit justifies the fee. AFAs can help firms communicate the value and the results of the services rendered. They should also pair the client's needs and expectations with the method that most equitably measures the value of the service.

2. **Proper tracking will help develop best practices.** Some law firms have created committees to track each AFA from start to finish. By recording the details of each engagement and the results, firms can build a library of scenarios and the AFAs used for each and then leverage them for future engagements.

3. **Hourly billing is still a strong option.** Tasks that are especially time intensive or perhaps out of the control of the law firm still lend themselves best to an hourly basis approach. Yet, even with that being the case, client demands may force you into an AFA.

AFAs have been prevalent in the industry long enough that it is clear that the paradigm shift in the attorney-client relationship is here to stay. Successful firms will remain proactive by analyzing the variables related to AFAs that work best not only to maintain the client relationship, but to positively impact the firm's bottom line. ■

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What's Considered an AFA?

AFAs include any fee arrangement that is not based on hours mutliplied by rates. These include blended hourly rate, fixed- or flat-fee plus hourly rate, and tax-based rate arrangements. AFAs are separate from alternative billing arrangements. To read more about the advantages and disadvantages of some of the primary AFAs, read one of our newsletters from our archive.

Understanding Partners’ Capital Accounts

The challenges law firms have experienced since the onset of the recession have been widely documented, but as the recovery continues at a sluggish pace, law firms are shifting their focus to the challenges that lie ahead. After years of layoffs and diminished or negative growth, law firms are seeing increasing partner turnover. Too often these departing partners are surprised at the status of the capital accounts, leading to real and potential disputes with management. To proactively address this issue, we believe law firm management should ensure that partners and senior associates (potential partners) understand the basic concepts pertaining to partners’ capital accounts.

A partner’s ownership interest in a partnership is tracked through the maintenance of a capital account. Failure to pay attention to the tax basis schedules and capital account balances can trigger unintended tax consequences.

A law firm accounts for its operations annually and its annual financial results are converted to tax basis for the purpose of filing annual income tax returns. Each partner has his/her own tax basis capital account, which is adjusted upward or downward depending on the specific adjustment.

A partner’s tax-basis capital account is **increased** by:

- A partner’s initial capital contribution to the partnership (normally a cash contribution);
- The amount of additional money and the adjusted basis of additional property contributed to the partnership;
- A partner’s distributive share of partnership taxable income; and

- A partner’s share of partnership tax-exempt income.

A partner’s tax-base capital account is **decreased** by:

- The amount of money and the adjusted basis of property distributed to the partner. Distributions can be in the form of cash draws or disbursements made on a partner’s behalf (such as retirement plan contributions, self-employed health insurance, automobile allowance, composite tax payments, etc);
- A partner’s distributive share of partnership taxable losses; and
- A partner’s share of nondeductible partnership expenses (e.g., political contributions, club dues, life insurance, or the disallowed 50 percent of travel and entertainment expenses).

The computation of a partner’s tax-basis capital account is very similar to the calculation of a partner’s tax basis in his/her partnership interest. The largest difference between the two is that the tax-basis capital account does not take into account the partner’s share of partnership liabilities, or optional basis adjustments under IRC Sec. 754. A partner’s share of liabilities is important in situations where a capital account becomes negative as a result of losses and non-deductible expenses.

Tax-basis capital accounts provide a shortcut to compute a partner’s tax-basis in their interest. To determine the tax consequences of a partnership transaction, one must take a partner’s tax-basis capital account, add back the partner’s share of partnership liabilities, and adjust for any inside/outside basis differences.

The above computation can be used to determine if a partner:

- Has enough basis to deduct a partnership loss;

- Will recognize gain on a contribution to or distribution from the partnership; or
- Will recognize gain or loss on a disposition of his/her partnership interest.

In addition, if a partner has a negative tax-basis capital account, it usually represents the minimum gain he/she would recognize if the partnership were to terminate or if the partner were to sell his/her interest for no cash consideration.

It is important to remember that GAAP and tax capital accounts may differ (for example, due to accelerated depreciation for tax purposes). When a partner leaves the firm, his/her payout is normally based on GAAP capital account. Accordingly, where GAAP capital account is larger than tax capital account, the difference will be taxable to the partner and likely result in ordinary income.

While the partnership's accountant is responsible for keeping track of the partners' capital accounts, it is each partner's responsibility to review such schedules and keep track of his/her individual tax basis schedules in order to avoid unintended tax consequences.

Management's responsibility is to educate the partners on the factors that impact their capital accounts to avoid potential disputes. ■

For more information on this and other tax matters as they relate to law firms and their partners, please contact Luda Mirne, CPA, MST, a senior manager in J.H. Cohn's Law Firm Industry Practice, at lmirne@jhcohn.com or 732-380-8646. Or, you may also contact Richard Puzo, CPA, J.H. Cohn partner and director of the Firm's Law Firm Industry Practice, at rpuzo@jhcohn.com or 973-364-6675.

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