

## Succession planning for law firms

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Not too long ago the stock market was an unwilling participant for those wanting to retire. Now portfolios have grown, the ability to retire has become more of a reality, and a generation is nearing traditional retirement ages. The American Bar Association (ABA) estimates that 50 percent of all partners in the nation's top 200 law firms were born between 1946 and 1964. The preliminary results of legal search firm Major, Lindsey & Africa's 2016 Partner Compensation Survey show that in the next five years, "one in six — 16 percent — of current partners will retire, and 38 percent in the next decade." This will be a significant talent drain for the legal industry and a major generational leadership transition for management. The impact is further exacerbated by the slow growth in new partners since 2009, as lower demand for legal services has persisted since the recession. While the topic of succession planning can be a sensitive discussion with aging partners, these departures will have a significant impact on your firm's future livelihood, profitability and cash flow.

### Impact of retirement

To better understand the impact of changes within your firm's senior partner ranks, firms should analyze the current demographics within their firm and quantify the impact of mandatory retirement dates, if applicable, and projected retirement dates. Management should then assess the impact of pending expected retirements with respect to key client relationships, practice area leadership, management leadership, practice development activities, unique technical competencies and other aspects of significance to the firm. Retirements projected in the next few years will logically take precedence from a succession planning perspective; however, key leadership transition plans should also be prioritized for the long term well-being of the firm.

Along with individual partner's uncertainty with respect to the timing of their retirements, another significant issue for law firm succession planning stems from partner compensation models that are designed, or perceived to be designed, around individual productivity metrics that do not adequately incentivize a partner to plan and execute an orderly pre-retirement transition for the greatest benefit to the firm. In an ideal world, a senior partner would be eager to:

- > Train and develop the leadership skills for the next generation;
- > Delegate client relationships to additional partners;
- > Share and introduce their professional network with others;
- > Assist new partners with practice development activities and reputation building, and
- > Transition from indispensable to supportive as they near retirement.

Accordingly, partner compensation systems should be reviewed and updated to promote effective partner retirement transitions. Partnership agreements should also be reviewed with an eye toward enhancing the incentive for partner retirement transitions. For instance, a longer pre-retirement notice period to the firm will allow more time to develop an effective transition plan. In addition, firms with deferred compensation or other retirement obligations may consider adding financial penalties for partners who do not comply with effective transition plans. The objective is not the penalty. Instead, the objective is to motivate improved succession planning so that firms maintain more of the value that the retiring partner helped to develop.

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## Preserving client relationships

Of foremost importance when planning for senior partner retirement is preserving your client relationships as the firm transfers responsibility to future leaders. Succession planning is the process of planning, documenting and communicating the gradual transfer of responsibilities for the client, and it is a critical and positive step to ensure you maintain client loyalty. This period of transition is a time when the intentional transfer of responsibilities and trainings should be assigned to the attorneys who will become the heirs apparent to the client relationship. If these transitions can be executed over a period of years rather than rushed in the last few months, then the likelihood of a successful transition is greatly enhanced. Partnerships with compensation arrangements heavily weighted toward work managed may want to alter those metrics as a partner begins to transition toward retirement.

Retirement census data should also be used to facilitate the preparation of a strategic cash flow and pro forma balance sheet and income statement which projects the economic impact of senior partners leaving the firm. A larger firm with a significant number of retirements may need a fairly precise monthly analysis, whereas fewer departures may only require an annual analysis or at a minimum, a calculation of the estimated financial impact of any one senior partner retiring. Profitability will most directly be affected by the potential loss of revenue and originations, plus potential retirement payments, offset by the corresponding decrease in partner compensation. It's important to keep in mind that there are other significant issues that should be addressed to limit surprises initiated by the departure of your senior partners.

Depending on your partnership agreement, partner paid-in capital will need to be returned to the retired partner over a predetermined period of time. Unless that return of capital is replenished by the remaining group of partners or new partners, cash flows will be reduced. If your law firm has debt, now is also a time to reacquaint yourself with the bank covenants. Many loans have restrictive covenants addressing the number of partners that can withdraw from the partnership at any given time. In addition, there are often partner guarantees that need to be re-assigned or restrictions that limit the amount of business that can be lost. Smaller firms may be required to maintain life insurance policies on senior partners with the bank listed as the beneficiary.

## Incentivize senior partners for succession planning success

When these succession planning exercises are completed, law firms will be more aware and cognizant of what client relationships and unique leadership or technical skills are at risk. The strategic cash flow and pro forma financial data should provide executive management with a valuable planning tool to navigate the inevitable retirement of senior partners, including planning for any unfavorable impact on profitability and cash flow. Incentivizing senior partners to plan their retirement transition process early will improve the likelihood of retaining client relationships during and after the retirement of senior partners.

## About the author

John Niehoff is the firm's partner-in-charge for the professional services practice, leading the firmwide strategy for providing Exceptional Client Service to law firms and other professional service businesses. He has been with the firm for more than 20 years and focuses on financial reporting, tax and operational issues unique to professional service businesses. He has extensive experience assisting law firms with specialized advisory projects tailored to achieve their financial objectives.