MUSICAL CHAIRS & RETIREMENT POLICIES

Ellen Freedman, CLM

Exit strategies vary greatly from firm to firm. Some work very well, others not so much. That doesn't necessarily mean that a strategy is flawed or perfect. We do know that once established, it's difficult for a firm to change the path to the door.

Law firms are fluid organizations which experience internal change over time. The marketplace changes continuously as well, and that is often a catalyst for additional change at firms; desired or not. Unless you're a freshly minted attorney, you have already witnessed significant changes, some good, some not so good.

There are many factors that have influenced established exit strategies.

- Size and complexity of firm
- Diversity in age, demographics and other factors
- Profitability and spread between large and small rainmakers
- Management structure — where the firm is on the spectrum from democratic to autocratic
- The norms at other comparable firms when the strategy is/was formed

What we clearly see is that over time even well-thought-out strategies can become unmanageable, and even detrimental to the health and stability of a firm. Right now we are seeing that clearly in the rapidly changing alignments of attorneys. Small and midsize firms are dissolving, merging and reforming at dizzying speed. Some of it is a result of pressures created by poor exit strategies or no exit strategies.

My PBA Law Practice Management hotline is ringing off the hook with people trying to navigate their own exit or those around them. You may think that is because no thought was made about this eventuality. And yes, I see a lot of that.

But more often it is that the thinking was applicable to different times and doesn't work now. Most often, it works for those who are the first in line to exit but not for those left behind.

As children, we played the game musical chairs. There is always one fewer chair than there are players. You march around the chairs until the music stops and then scramble to get seated. Those who have no chair available are out. Remove more chairs and start the music again. Eventually you have just a single chair and two people remaining. We know how it ends.

That's the scenario when I'm called. There is typically an exit strategy which calls for some payout to retiring stakeholders. It can be as little as the equity account balance. But often it's more. It may be a percentage of revenues originated on average over x-years before retirement. It may be a percentage of the total value of the firm, payable over a number of years. Sometimes it is just a flat number fished out of a cloud in the retiring stakeholder's mind; a self-worth evaluation if you will. Emotions run the highest in this scenario.

None of these strategies is necessarily wrong. All can work provided that the following factors exist:

- The firm is profitable and has stable revenues.
- The firm has continued to hire and develop people who will be able to produce hours and replacement revenues for those exiting.
- Those exiting have put the best interests of the firm ahead of their insecurity and compensation needs and have passed clients and referral sources to those who remain behind.

Here's a typical scenario from a hotline caller. A small firm with five partners and one associate, three partners are approaching retirement. The firm exit strategy calls for one-year notice, except for disability or illness. At exit time, a valuation of the firm is done. The departing stakeholder is paid 20% of the value in three equal yearly installments.

Each of the partners is an island in that they have their own distinct book of business. The three partners closest to retirement have not made any significant effort to transition clients or referral sources. The two younger partners have much smaller books of business. Sometimes the scenario is worsened because the more senior partners own the building and want to execute a long-term lease before they retire or be bought out on the building.

I get concerned calls from one or more senior partners. Each is worried that if they aren't the first to retire, or second, he will not get paid. Yes, they know they have built a house of cards which will collapse under its own weight following their departure. I most certainly get a call from the two younger partners, together or separately. They have made headway in building their skills, brand and book of business. But they know they will not be able to survive economically if they are also saddled with payouts. And what are they buying? What value is left behind for them? They don't want to be disloyal. They don't want to end a relationship in litigation. But they are marching around the chairs and see the inevitable conclusion.

I'm not a magician. There are no secret fixes. Senior partners who are depending on buyout will be sorely disappointed. Younger partners will have to leave to go on their own or move to another firm or the firm will have to become absorbed by or merge with another firm. And that is indeed what we're seeing in the marketplace.

Here is my advice for developing an exit strategy for your firm right now. Avoid getting stuck with a musical chairs situation years from now, because it won't end well.

1. Make it part of the firm culture that everyone plans for and is responsible for their financial situation at retirement. Establish one or more employee-funded retirement plans. Allow room for voluntary contributions by the firm when times are good. Don't lock yourselves into a plan that requires contributions from the firm when profits are low.

2. I am not a believer in mandatory retirement ages. I think many people are cast aside unnecessarily. But I am a believer in mandatory de-equitization at a given age, if it works for your firm's culture.

3. Be cautious about agreeing to pay out more than the value of a capital account upon retirement. If you do:

    a. Keep a sharp focus on the need to keep rebuilding the firm from the bottom.

    b. Formalize succession planning to start not less than five years ahead of anticipated retirement. It must include a continual increase in client work delegated to a successor. It must include introductions to referral sources. It must include opening doors

c. into spheres of influence so that an intended successor has the option of joining or not.

d. Think ahead about the realities of who owns the building and what happens when they retire. Real estate isn't guaranteed to increase in value.

These are not necessarily pleasant things to think about. They are certainly not easy things to think about. Nonetheless, its essential to have a strategy in place that has the flexibility to work when the marketplace or firm demographics change.

A version of this article originally appeared in the March 18, 2019 issue of the Pennsylvania Bar News.