Law Firm Partnership Agreements

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Healthy partner relationships are based on both mutual respect and, most importantly, a comprehensive written agreement.

LAWYERS TEND to live with the status quo and do nothing so long as they are not faced with crisis. However, they should not be lulled into a sense of false security because nothing bad has happened. It takes only one issue arising at an inopportune moment to put a firm at great risk.

Give some thought to what would happen in your present firm if one of your partners became disabled, died, or elected to withdraw and set up a practice across the street. Does your partnership agreement adequately spell out the rights and duties of the partners under the circumstances? Or would there be unanswered questions leading to controversy or worse? The discussion that follows will raise a number of issues that require attention in the partnership agreement.

PARTNERS • The agreement should identify the partners and provide the process for adding new partners to the ranks. How is that decision going to be made? What is required in terms of a vote? Is a simple majority sufficient or should the admission of new partners require a supermajority? Should there be a buy-in and if so how is the amount calculated?

Most firms believe that the admission of partners is one of the most significant decisions to be made and new partners should not be added on a close vote. As a result, firms typically require a supermajority vote, which could be a two-thirds vote, a three-quarters vote, or in small firms perhaps a unanimous vote.

The next question is should there be a buy-in requirement and if so in what amount? Smaller firms tend to require new partners to pay for their interest in the firm. The buy-in can provide additional capital for the firm or can be used to compensate the existing partners for their investment and sweat equity in creating the law firm or in growing it to its present size. The best approach in setting the amount is to include in the partnership agreement the formula for determining the value of the firm, to which the new partner's percentage interest can be applied. Most firms allow for a buy-in over several years, or in the alternative, the firm directs the new partner to a friendly bank, with the firm co-signing the note. Firms that do have a buy-in provision also typically provide for a payment to partners upon departure.

In recent years, an increasing number of large firms have adopted a free buy-in. Under that approach, there are no payments to departing partners. That is referred to as "free in, free out."

Obviously, the partnership agreement will need to specify whether there is a single tier of partners or two tiers of partners. If the firm has two tiers of partners, it will be necessary for the agreement to specify the differences in their rights and duties. The second-tier partners will likely have a different ownership interest in the firm, different voting rights, and a different compensation arrangement. Second tier partners are not normally required to buy in and are not responsible for the debts of the firm.

Another area of partnership concern is the topic of outside activities. Typically, the partnership agreement provides that all monies earned from the practice of law are to be paid to the partnership. There are a number of income opportunities related to the law that would not come under a strict definition of the practice of law. For example, should payments received from teaching a law school class in the evening be treated as revenue to the law firm? How about royalties from a book on governing law firms? How about monies received from serving on a board of directors? Or holding political office? These can be difficult questions to answer if not addressed in advance.

DURATION • The Uniform Partnership Act controls issues not specifically addressed in the partnership agreement. That would mean that unless the duration of the partnership is addressed, the death of one of the partners would terminate the partnership. As a result, most law firm partnership agreements have a provision that the partnership will survive the death of a partner. This provision is not necessary in a professional association or a limited liability company.

CAPITAL • Law firms require capital to fund start-up, to survive irregular cash flow, to provide the resources for expansion, or to take on costly projects. New capital also becomes necessary when senior partners reach retirement age if their departure from the firm requires a return of their capital.

Law firms have limitations with regard to supporting their financial needs. Because law firms in the United States are not allowed to have outside investors, those sources are limited to capital contributions of partners, loans from partners, loans from banks or from relatives, and loans in the form of leased equipment. Responsible financial management requires a balancing all of those sources of money with capital contributions from existing and new partners as an important funding mechanism.

Although there are a few large institutional firms sufficiently successful to not require a capital contribution, most firms are set up to receive capital contributions from new partners. The amount of the capital contribution to be made by new partners should either be specified in the agreement or better yet based on a formula described in the agreement. Once a partner makes a capital contribution, that capital account is maintained, with additions and subtractions from time to time, until the partner's departure.

Many law firms are undercapitalized. Give consideration to your capital structure and consider retaining some earnings within the partnership to strengthen the financial standing of the firm.

VOTING • The partnership agreement should address several aspects of voting. For starters, the firm needs to decide whether to have per capita voting or weighted voting. Per capita means one partner one vote and is utilized by most partnerships. Weighted voting means that a partner's vote is weighted depending upon the partners' respective interests in the firm. For example, if the interest of partners A, B, and C are 55 percent, 25 percent and 20 percent respectively, their votes would be weighted in those same proportions. In that simple example, partner A would control every majority vote based on a 55 percent interest in the firm. On the other hand, if an issue required a supermajority of two-thirds, partner A and one other partner could control the vote, but partners B and C could not control the vote because their total interest in the firm is less than the two-thirds vote necessary.

This brings us to the consideration of majority votes and supermajority votes. A typical partnership agreement will set forth certain issues that will require more than a majority vote. The issues identified as requiring a supermajority vote would be those deemed most significant and might include the admission of new partners, the purchase or sale of real estate, an offer of partnership, a merger, etc. Any issue not specified as requiring a supermajority vote would be decided based on a simple majority vote.

MANAGEMENT • Partnership agreements for relatively small firms will provide that the management of the firm is reserved to the partners to be delegated as they deem appropriate from time to time. Other partnership agreements may provide the basic provisions setting up a management committee structure or a managing partner structure. Regardless of the management approach adopted, care should be taken to make certain the partnership agreement remains free of the details.

PROFITS • The distribution of profits is a critical provision in a partnership agreement. Although some firms described in detail how the profits will be allocated, the better course is to create the structure in the partnership agreement and leave the detail to a vote of the partners. You don't want a partnership agreement that has to be amended every time there is a change in allocating the compensation.

The agreement may provide a broad general description of the allocation process. For example, the agreement may state that "the profits will be allocated based on a subjective system as determined by the partners from time to time." Or, the agreement may state that "the profits will be allocated based upon a formula as determined by the partners from time to time." The goal is for the partners to be able to amend the factors or adjust compensation as among the partners without requiring an amendment of the partnership agreement.

RETIREMENT • Retirement can be either voluntary or mandatory. Firms that saw senior partners work into their 80s, with all the attendant risks, were the first to consider adopting mandatory retirement at a certain age. The mandatory retirement concept can be modified by a provision that allows for annual contracts after the retirement age as determined by management on a case-by-case basis. In that circumstance, the partner who still brings great value to the firm can be retired from the partnership under the mandatory retirement provision and then enter into a one-year contract, subject to renewal, for a certain level of services on an annual basis. This is an excellent way to allow protection from the older partner who is both unproductive and a risk, while at the same time allowing the valuable lawyers to work beyond the mandatory retirement age at the discretion of the firm.

Most firms have eliminated provisions for unfunded retirement benefits. The unfunded arrangements were simply agreements that the partnership would support retired partners from the earnings of the firm. Unfunded retirements were commonplace in the 1950s and 1960s, but as firms grew the challenges of producing adequate compensation for the working partners as well as benefits for retired partners made unfunded benefit unrealistic. In fact, some firms liquidated just to get out from under oppressive retirement benefit commitments.

Currently, firms often limit the retiring partner to a return of capital and any benefits under a funded retirement plan. In the interest of fundamental fairness, transitions have been managed by allowing partners nearing retirement age to retire under the existing unfunded system, while putting in place funded retirement benefits for the younger partners.

DISABILITY • One of the most difficult decisions unexpectedly forced on a partnership is how to handle compensation to the partner who becomes disabled. The partners' loyalties and instincts may be generous, but the financial strain on the partnership can be devastating. If the partnership agreement does not have a guiding provision there will be intense pressure on the partners to continue paying the disabled partner irrespective of the firm's financial situation. Partners support each other and it may be perceived as unseemly to cut off compensation to a disabled partner.

The partnership agreement needs to specify the obligation of the partnership to a disabled partner. There are a number of different approaches, some providing full compensation for a certain period of time while others may provide partial compensation for a period of time. The important factor here is that all partners understand the rules going in. The firm may elect to provide disability insurance after a certain period, thereby limiting the firm's obligation. Other firms will leave it to the partners to select and pay for their own disability insurance, knowing that the commitment of the firm is limited.

The agreement should address temporary disability and permanent disability, with different provisions in terms of the compensation paid. In drafting the agreement the partnership should also consider how disability determinations are going to be made. What if there is disagreement? How are disagreements resolved? It is safest to have a provision with a process for making these determinations, which frequently include acquiring a doctor's opinion.

DEATH • If the partnership survives the death of a partner, there needs to be a provision for paying the estate of the deceased partner that partner's share of the value of the partnership. Does the estate of the deceased partner simply receive a return of capital invested or is the estate of the deceased partner entitled to receive its pro-rata share of the value of the partnership? If the plan is to employ the latter, then the question arises as to how the partnership is to be valued. Typical business appraisal methodology can be applied to a law partnership, but it may be better to provide a specific formula in the partnership agreement. The formula can address the specifics of a law business, such as how to treat work-in-process, receivables and contingency cases.

The final issue concerning the death of a partner involves the right to continue to use the name of the deceased partner in the firm name. Assuming there are no local ethical rules to the contrary, most lawyers would prefer to continue the brand for marketing purposes rather than constantly changing the name of the firm. A simple provision in the partnership agreement will give the remaining lawyers that choice.

WITHDRAWAL • A partner's decision to withdraw from the firm raises similar questions concerning the value of the partnership interest. Some firms treat withdrawal the same as death or expulsion while other firms create a disincentive by employing a different financial arrangement should a partner voluntarily withdraw. There is no requirement that a departing partner be treated the same irrespective of the reason for the departure.

There are additional issues concerning the rights and duties of the partner to the firm after a decision has been made to depart. So long as the partner is a member of the firm, the partner owes the primary duty to the firm. It would be improper for the departing partner to give clients advance notice or lobby them to elect to follow the departing partner to a new practice setting. The best way to manage a departure is to have the rights and responsibilities clearly set forth in the partnership agreement. Typical provisions include:

- The departing partner's duty to not take any action that compromises the interests of the firm;
- A requirement that the departing partners provide the other partners with a certain notice before any departure;
- The right of the remaining partners to accelerate the departure date should they deem it to be in the best interests of the firm;
- The specific requirement that a departing partner not notify any client of the intended departure prior to a joint letter signed by both the departing partner and a representative of the firm;
- A sample of the letter to be provided clients of the departing partner outlining that the client has a choice of having that client's file remain with the firm or be turned over to the departing partner.

These provisions reinforce the general obligations of a partner and avoid uncertainty.

EXPULSION • A provision for expulsion of a partner is necessary in order to protect the partnership from a partner who for one reason or another is no longer willing or able to be a productive member of the group. For example, a if a lawyer is disbarred and can no longer practice law than that lawyer no longer qualifies to be a partner in a law partnership. The partnership agreement should provide that a disbarred lawyer is automatically expelled. There may be other circumstances in which the partnership wants to clearly retain the discretionary right to expel a partner. In order provide a basis for exercising that discretion, the partnership agreement should specify those circumstances that would give rise to possible expulsion. The circumstances could include bankruptcy, suspension from the practice of law, conviction of a crime, violation the partnership agreement or other actions that are harmful to the partnership. The expulsion of a partner is one of those issues that should be decided based on a supermajority vote and not a simple majority.

Under the circumstances, the partnership agreement needs to specify the nature of the notification to clients and the rights of the expelled partner to a return of capital and/or a payment for the expelled partners interested in the firm.

DISSOLUTION • The dissolution and liquidation of a law partnership needs to proceed in an orderly fashion in order to protect the rights of the firm's clients and the interests of the partners. As might be expected, at a time of impending dissolution, the partners are often more focused on their individual career futures than in winding up the old partnership. In order to avoid a chaotic situation, the partnership agreement needs to specify the duties and responsibilities of each partner to the partnership in the dissolution process.

When problems arise that are not covered by an agreement, it will be impossible to get a resolution that is in the best interest of the firm due to lawyers arguing from the perspective of their own self-interest. Lawyers who have faced that dilemma have learned the hard way how important it is to get an adequate comprehensive agreement in place before problems arise. Now is the time to correct any deficiencies in your law firm agreement.

CONCLUSION • There will always be a temptation to put the partnership agreement on the back burner. There will always be pressing client matters that take up almost every moment of a firm's time. But at some point, a problem in the management of the firm will arise and if the written agreement was overlooked due to the everyday pressures of a law practice, that problem will sap the vitality and success of the firm, or worse. Law firms without written agreements, or without adequate agreements, are waiting for trouble to strike. Law firms that have them will avoid that trouble—or at least have a way to manage it well.

PRACTICE CHECKLIST FOR
Law Firm Partnership Agreements

For a law firm to serve its clients, it needs to function well. To assure that level of high function, the firm needs a well-considered, written partnership agreement.

- With respect to the partners, the agreement should address:

__ The process for adding new partners to the ranks;
__ The requirement of a vote and whether there should be a buy-in requirement and, if so, in what amount;
__ Whether there is a single tier of partners or two tiers of partners;
__ Outside activities;

- The agreement should have a provision that the partnership will survive the death of a partner.

- The amount of the capital contribution to be made by new partners should either be specified in the agreement or better yet based on a formula described in the agreement.

- The partnership agreement should address several aspects of voting. For starters, the firm needs to decide whether to have per capita voting or weighted voting.

- Partnership agreements for relatively small firms will provide that the management of the firm is reserved to the partners to be delegated as they deem appropriate from time to time.

- With respect to the distribution of profits, the best course is usually to create the structure in the partnership agreement and leave the detail to a vote of the partners.

- Retirement can be either voluntary or mandatory. The mandatory retirement concept can be modified by a provision that allows for annual contracts after the retirement age as determined by management on a case-by-case basis.

- The partnership agreement must specify the obligation of the partnership to a disabled partner. The agreement should address temporary disability and permanent disability, with different provisions in terms of the compensation paid.

- If the partnership survives the death of a partner, there needs to be a provision for paying the estate of the deceased partner their share of the value of the partnership.

- Some firms treat withdrawal of a partner the same as death or expulsion while other firms create a disincentive by employing a different financial arrangement should a partner voluntarily withdraw. There is no requirement that a departing partner be treated the same irrespective of the reason for the departure. Typical provisions addressing withdrawals include:

__ The departing partner's duty not to take any action that compromises the interests of the firm;
__ A requirement that the departing partners provide the other partners with a certain notice before any departure;
__ The right of the remaining partners to accelerate the departure date should they deem it to be in the best interest of the firm;
__ The specific requirement that a departing partner not notify any client of the intended departure before a joint letter signed by both the departing partner and a representative of the firm;
__ A sample of the letter to be provided clients of the departing partner outlining that the client has a choice of having that client's file remain with the firm or be turned over to the departing partner.

- A provision for expulsion of a partner is necessary in order to protect the partnership from a partner who for one reason or another is no longer willing or able to be a productive member of the group.

- To avoid a chaotic situation, the partnership agreement needs to specify the duties and responsibilities of each partner to the partnership in the dissolution process.