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Managing equity ownership in a law firm

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Howard Hackney

Howard escaped from Grant Thornton UK LLP in 2008 where he had been a partner for over 25 years to establish his own boutique practice. During his time at Grant Thornton he was head of professional practices for the North West and head of family businesses for the UK. At Grant Thornton he had a variety of roles including office Managing Partner, North West regional marketing partner and membership of the partners appointments panel. Howard specialises in advising mid market professional practices and family businesses. In 2002 he won the CBI's national award as "Best Business Adviser".

Howard's focus is providing "special projects" advice to firms with up to 20 partners. His experience extends from highly profitable sole practitioners to advising 3 of the top 100 law firms. Recent assignments have included sales of law firms, partnership disputes, fund raising, LLP and ltd company conversion, ABS conversions, sales and acquisitions.



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Mark Briegal

Mark Briegal is a partner at Aaron & Partners LLP, a specialist commercial law firm. He heads up the Professional Partnerships team which covers all aspects of professional partnership from formation to dissolution including disputes, mergers and acquisitions and regulatory matters. Mark mainly advises solicitors.

By way of background, Mark studied Classics at Cambridge University and graduated into the City, working in international banking and management consultancy before converting to law.

Mark helped to establish the North West branch of the Association of Partnership Practitioners.



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Agenda

- Introduction & case study background
- Capital structure
- Pension & property
- Partner replacement
- Profit sharing regime
- Governance
- Expulsion

Meet the Team!

- RT & Co LLP - founded as LSF & Co. in 1976
- Converted to LLP in 2005
- Currently 5 Members:

<i>NAME</i>	<i>AGE</i>	<i>PROFIT SHARE</i>	<i>CAPITAL</i>
Alice Arnold	56	20%	£ 150,000
Brian Barlow	62	25%	£ 250,000
Cathy Clarke	39	15%	£ 75,000
David Dawes	52	20%	£ 150,000
Edward Eagle	57	20%	£ 150,000

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Capital Structure

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Value – the starting point

- Capital = shares → contribute based on real value
- Process driven different from “collegiate” practices
- Approaches
 - Net assets – watch hidden assets & liabilities
 - Earnings – goodwill = net assets less earnings value
- No discount for minority & have agreed formula
- Earnings
 - Maintainability of profits
 - Adjust for “partner” remuneration
 - What multiplier?



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Subjective issues

- “Real” Goodwill
 - Less likely in collegiate practice
 - Often excluded as between partners
 - But likely to have real value in process driven firm
 - Difficult to fund
 - Multiplier of sustainable normalised profit = whole firm
 - % fee income only for smallest firms
- “WIP” goodwill
 - Often off balance sheet – watch FRS102
 - Usually taxed on exit at 10%



Subjective issues

- Contingent WIP
 - Often not in accounts for tax reasons
 - Has real value, but what is it?
 - What is fundable – firm & individual
 - £1,000 per case X 1,000 = £1m but on average ½ way through = £500k, then a x% discount



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Partner capital

- Separate profit sharing from capital ownership
- Need to distinguish between types
 - Fixed = ownership stake/share
 - Current
 - Tax provision
- Current account to be freely withdrawable
 - So sufficient bank facilities needed
 - Fixed capital set sufficiently high
- Fixed capital often borrowed personally (off Balance Sheet)
- Tax provisioning policy – complex but highly recommended



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RT & Co LLP - Balance sheet

Fixed assets	<u>75,000</u>
Current assets	
Contingent WIP	0
WIP	500,000
Accrued income	350,000
Debtors from clients	285,000
Disbursement debtors	<u>75,000</u>
	<u>1,210,000</u>
Current liabilities	
Trade creditors	10,000
Bank borrowing	500,000
	<u>510,000</u>
Net current assets	<u>700,000</u>
Net assets	<u><u>775,000</u></u>
Partner capital	<u><u>775,000</u></u>



But what about WIP?

Fixed assets	75,000	75,000
Current assets		
Contingent WIP	0	300,000
WIP	500,000	500,000
Accrued income	350,000	350,000
Debtors from clients	285,000	285,000
Disbursement debtors	75,000	75,000
	<u>1,210,000</u>	<u>1,510,000</u>
Current liabilities		
Trade creditors	10,000	10,000
Bank borrowing	500,000	500,000
	<u>510,000</u>	<u>510,000</u>
Net current assets	<u>700,000</u>	<u>1,000,000</u>
Net assets	<u>775,000</u>	<u>1,075,000</u>
Partner capital	<u>775,000</u>	<u>1,075,000</u>



Points system – capital and “dividend”

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Alice Arnold	80	90	100	100	100
Brian Barlow	100	100	100	90	80
Cathy Clarke	60	70	80	90	100
David Dawes	80	90	100	100	100
Edward Eagle	80	70	60	50	0
	400	420	440	430	380

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Alice Arnold	20.0%	21.4%	22.7%	23.3%	26.3%
Brian Barlow	25.0%	23.8%	22.7%	20.9%	21.1%
Cathy Clarke	15.0%	16.7%	18.2%	20.9%	26.3%
David Dawes	20.0%	21.4%	22.7%	23.3%	26.3%
Edward Eagle	20.0%	16.7%	13.6%	11.6%	0.0%
	100.0%	100.0%	100.0%	100.0%	100.0%

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Alice Arnold	215	230	244	250	283
Brian Barlow	269	256	244	225	226
Cathy Clarke	161	179	195	225	283
David Dawes	215	230	244	250	283
Edward Eagle	215	179	147	125	0
	1,075	1,075	1,075	1,075	1,075



RT & Co LLP - implications

	<u>Points</u>	<u>Existing capital</u>	<u>Add WIP</u>	<u>Revised capital</u>	<u>Revised capital</u>
Alice Arnold	80	150,000	60,000	210,000	215,000
Brian Barlow	100	250,000	75,000	325,000	268,750
Cathy Clarke	60	75,000	45,000	120,000	161,250
David Dawes	80	150,000	60,000	210,000	215,000
Edward Eagle	80	150,000	60,000	210,000	215,000
	<hr/> 400	<hr/> 775,000	<hr/> 300,000	<hr/> 1,075,000	<hr/> 1,075,000 <hr/>

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Gearing

- The ratio of external funding (bank) to partner capital
- Primarily a banking issue
- Is also a partner risk issue
- Banks rarely lend > one:one



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Borrowing

- Can be personal or in the practice
- If in practice LLP and Ltd Company are better
 - Banks ability to take a charge
 - Partners can limit their risk (but personal guarantees)
- Personally for capital
 - Off balance sheet
 - Banks will look to both personal assets AND underlying practice
 - Will look at lending in “the round”
 - Try to have a separate bank from that for the practice



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RT & Co LLP – geared

Fixed assets	75,000	75,000	75,000
Current assets			
Contingent WIP	0	300,000	300,000
WIP	500,000	500,000	500,000
Accrued income	350,000	350,000	350,000
Debtors from clients	285,000	285,000	285,000
Disbursement debtors	75,000	75,000	75,000
	<u>1,210,000</u>	<u>1,510,000</u>	<u>1,510,000</u>
Current liabilities			
Trade creditors	10,000	10,000	10,000
Bank borrowing	500,000	500,000	800,000
	<u>510,000</u>	<u>510,000</u>	<u>810,000</u>
Net current assets	<u>700,000</u>	<u>1,000,000</u>	<u>700,000</u>
Net assets	<u><u>775,000</u></u>	<u><u>1,075,000</u></u>	<u><u>775,000</u></u>
Partner capital	<u><u>775,000</u></u>	<u><u>1,075,000</u></u>	<u><u>775,000</u></u>

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Pensions and Property

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A personal view



- Genuine self administered arrangements
- Changes reinforce firm belief in pension planning
 - Tax benefits
 - Security for the individual
 - Potential cash release of money in existing properties
- Summer 2015 budget
 - Lifetime limit £1m
 - Restricted contributions if income >£150k
 - 3 year carry forward relief – potential £160k pre 5/4/18
 - To utilise at best tax rate spread over two tax years
- Complex but worth it and take advice

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Tax benefits

- Tax relief on contributions at marginal rates
- But make sure sufficient income taxed ideally at 40%+
- Tax free growth
- 25% of fund available as tax free lump sum
- Fund is IHT free – until age 75
- If death post 75 – 45% tax or marginal rate
- Added benefit that usually protected in a bankruptcy!!

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Commercial property

- Alignment of partners' & firm's interests
- Often a sensible approach
- Rental returns of 5%-10%
- Tax free growth
- Property purchased at 40%+ discount
- Open market rent to be paid – tax deductible & tax free
- For existing props. can release cash (watch CGT & SDLT)
- Partner issues
- Can buy <100%
- Try to align ownership with points
- Need for agreement with partners on exit
- Funding



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Funding parameters

Cost of property	<u><u>500</u></u>
Pension contribution Net	128
Tax refund	<u>32</u>
Gross contribution (over two tax years)	160
Existing fund transfer	<u>173</u>
Fund value	333
Borrow 50% of fund	<u>167</u>
Total funding	<u><u>500</u></u>
Further tax saving at say 20%	(32)
Initial contribution	<u>128</u>
Net cost of pension contribution	<u><u>96</u></u>



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Replacement Partners

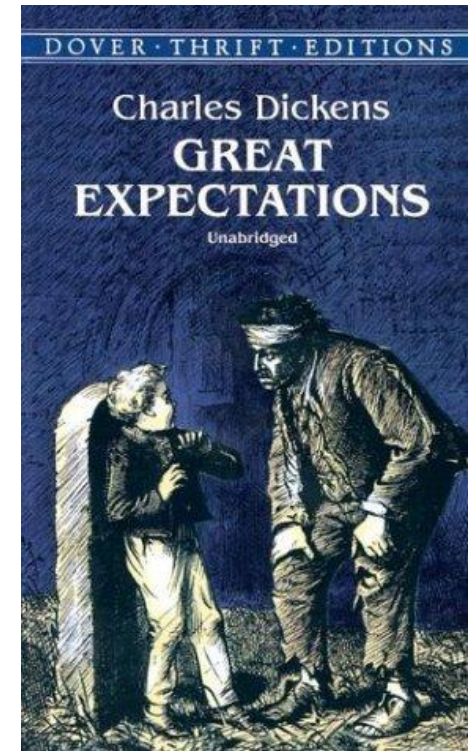
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New Partner Expectations

- Reward, status & influence
- Support and Guidance
- Training
- Involvement
- Clear Expectations:
 - Output
 - Rewards
 - Measurement Criteria
- Resources to Deliver Results



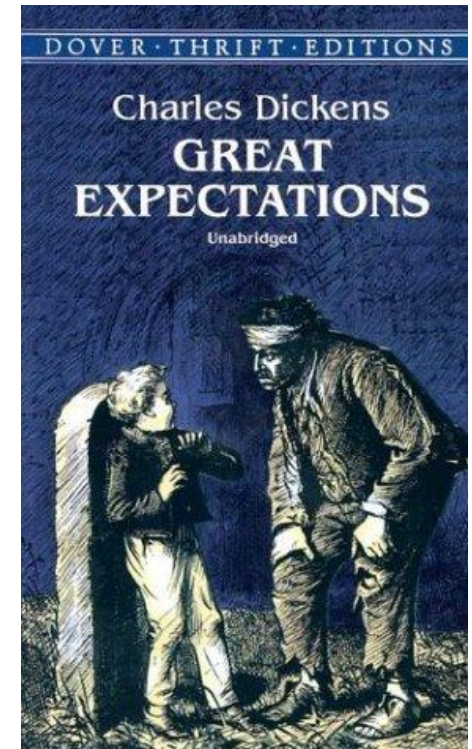
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Firm's expectations

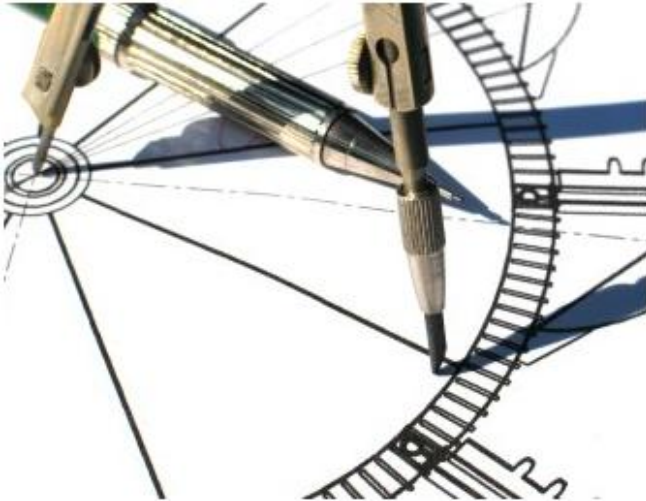
- Being good at law is a given!
- You now have to manage a team and a business:
 - Strategic Planning
 - Business Development
 - Financial Management
 - Leadership
 - Staff management
 - Motivation
- Achieve results through others



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Management attributes

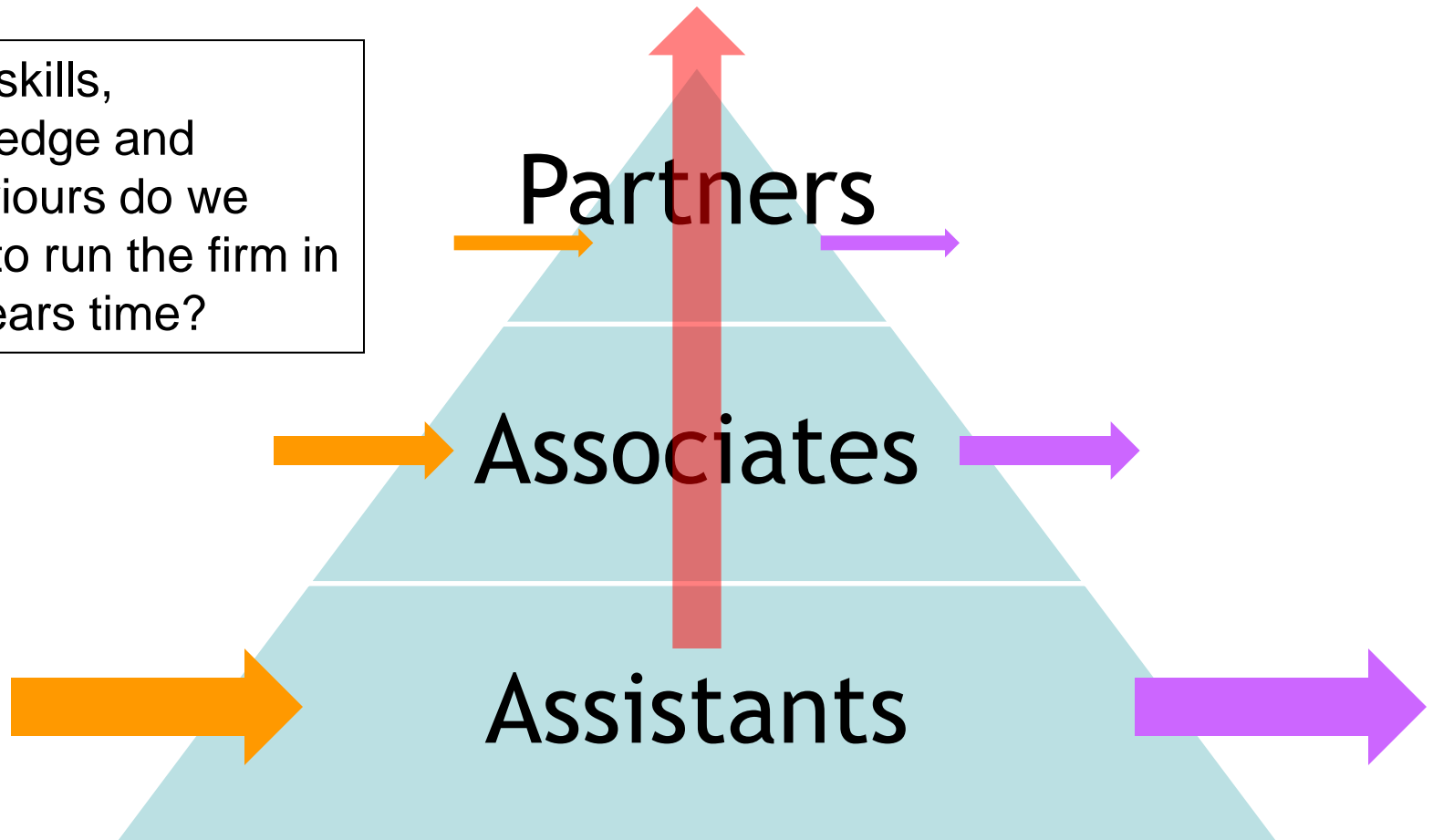
- The desire
- The skills
- Support
- Motivation
- People
- Organisation
- Intellect
- Credibility
- Being good at the law (a given!)



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Talent Management and Succession Planning

What skills,
knowledge and
behaviours do we
need to run the firm in
five years time?



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SRA – financial viability indicators

- Drawings in excess of profits
- Borrowings in excess of net assets
- Heavy dependence on high overdraft borrowing
- Inability to measure or control financial performance
- Over dominant senior/managing partner
- Lack of transparency of financial performance
- Narrow focus on single type of work
- Weak billing & cash collection processes





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Profit Sharing Regime

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Profit sharing theory

- Equality via lockstep
- On performance
- A mixture of the two
- Drawings policy
 - Linked to anticipated profit share & realistic forecasts
 - Regular monthly amounts (like a salary)
 - Surplus drawn after accounts available

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Objectives

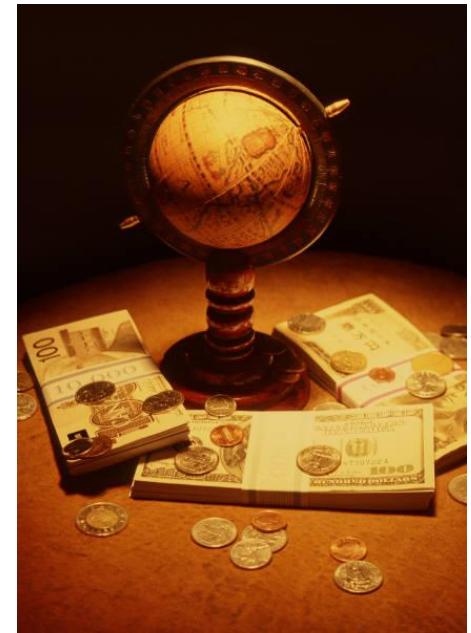
- Fairness
- Simple & understandable
- Potential to:
 - Motivate
 - Grow the cake
- Flexible
 - Allows new partners
 - Super/under performer
 - No need to revisit every year
- Key year end issues:
 - How much can I draw?
 - How do I compare with my mate down the corridor?



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Our preference (probably)

- Interest on capital – allows borrowing & compensates for unequal current accounts
- Rate for job/fixed prior share
- Performance pool – **BUT** divisive
- Dividend based on points
- Possibly departmental/geographic pool





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Governance

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RT & Co LLP - Agreement

- 2005 Members' Agreement:
 - Signed by Alice, Brian, David, Edward & Freddie
 - Not signed by Cathy
- Drew up themselves based on partnership agreement
- No "Red Socks" Clause
- Specifies goodwill on retirement
- Specifies capital repaid at 6 months and 12 months





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Governance & Talent

- Does your structure attract the best talent?
- Do your top performers see a reason to stay?
- Is there an obvious career path?
- Is career progression discussed?

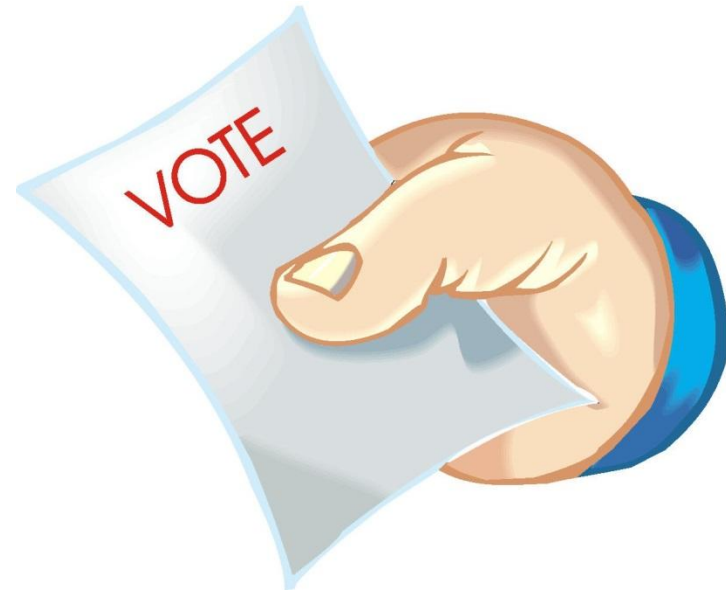
- Profit share
- Entrepreneurial freedom v. control



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Decision Making & Governance

- Partners' Meetings
- Management Board
- Voting rights
- Control
- Dispute resolution
- A balance needed



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Is the Agreement Adequate?

- Need an Agreement:
 - Partnership Agreement
 - LLP Members' Agreement
 - Shareholders' Agreement
- Key clauses:
 - Governance
 - Management
 - Profit Share
 - Capital
 - Retirement
 - Expulsion
 - Repayment
 - Dispute Resolution





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Expulsion

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Expulsion – Partnerships and LLPs

- Not allowed unless in Partnership or Members' Agreement
- Expel for gross misconduct
- Always have an expulsion or **red socks** clause if 5+ partners
- Need to be able to remove (in good faith) if just don't fit
- Who decides? What percentage required?
- Quicker payment or reduced restrictions?
- Cannot discriminate
- Ensure Consensus
- Follow Process
- Otherwise negotiate or dissolve





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Expulsion - Companies

- In a Limited Company structure, directors are employees
- Employment rights apply
- If no gross misconduct, then Settlement Agreement
- Beware constructive dismissal
- Beware minority shareholder protection (s994 CA2006)
- Need a Shareholders' Agreement

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Conclusion

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Summary

- Discuss your expectations
- Consider the expectations of partners joining or leaving
- Talent management
- Define value
- Capital and points
- Property
- Governance
- Good agreements
- Know your options



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Thank you

Thank you for participating.

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