

Second Edition

# Partnership Agreements for Law Firms

NICHOLAS WRIGHT



PUBLISHED BY **ark** GROUP ark IN ASSOCIATION WITH

**mp**  
managingpartner

**WRIGHT SON & PEPPER LLP**  
SOLICITORS

## Partnership Agreements for Law Firms, Second Edition

is published by Ark Group



### UK/EUROPE OFFICE

Ark Conferences Ltd  
Paulton House  
8 Shepherdess Walk  
London N1 7LB  
United Kingdom  
Tel +44 (0)207 549 2500  
Fax +44 (0)20 7324 2373  
publishing@ark-group.com

### NORTH AMERICA OFFICE

Ark Group Inc  
4408 N. Rockwood Drive  
Suite 150  
Peoria IL 61614  
United States  
Tel +1 309 495 2853  
Fax +1 309 495 2858  
publishingna@ark-group.com

### ASIA/PACIFIC OFFICE

Ark Group Australia Pty Ltd  
Main Level  
83 Walker Street  
North Sydney NSW 2060  
Australia  
Tel +61 1300 550 662  
Fax +61 1300 550 663  
aga@arkgroupasia.com

### Editor

Stephanie Ramasamy  
sramasamy@ark-group.com

### UK/Europe marketing enquiries

Robyn Macé  
rmace@ark-group.com

### ISBN: 978-1-907787-63-8 (hard copy)

978-1-907787-64-5 (PDF)

### Head of content

Anna Shaw  
ashaw@ark-group.com

### US marketing enquiries

Daniel Smallwood  
dsmallwood@ark-group.com

### Copyright

The copyright of all material appearing within this publication is reserved by the author and Ark Conferences 2011. It may not be reproduced, duplicated or copied by any means without the prior written consent of the publisher.

### Managing director

Jennifer Guy  
jguy@ark-group.com

### Asia/Pacific marketing enquiries

Steve Oesterreich  
aga@arkgroupasia.com

ARK1688

Second Edition

# Partnership Agreements for Law Firms

NICHOLAS WRIGHT



PUBLISHED BY **ark8** IN ASSOCIATION WITH

**mp**  
managingpartner

**WRIGHT SON & PEPPER LLP**  
SOLICITORS

# Contents

Executive summary.....	V
About the author.....	IX
Acknowledgements .....	XI
<b>Part One: Resolving the Current Issues in Partnership Agreements</b>	
Chapter 1: Partnerships, LLPs and limited companies.....	3
Chapter 2: Alternative Business Structures – Outside participation in legal firms .....	7
Chapter 3: Attracting new partners – LLPs and partnerships.....	13
Chapter 4: How is the partnership managed? .....	15
Chapter 5: Salaried and junior equity partners.....	19
Chapter 6: Discrimination in partnerships.....	21
Resolving the discriminatory issues in the partnership agreement.....	23
Chapter 7: Profit sharing .....	27
The equality system .....	27
Profit share by capital contribution .....	28
Seniority (lockstep) .....	28
Merit or performance systems .....	29
Hybrid profit-sharing systems .....	31
Variables in merit-based systems .....	32
Capital-based hybrid systems.....	33
Retirement annuities .....	34
Retaining profits.....	34
Chapter 8: Different categories of partner and new partners .....	37
Chapter 9: Additional benefits and provisions .....	41
The kinds of benefits .....	42
Flexible working arrangements.....	43

<b>Chapter 10: Supervision and disciplinary provisions .....</b>	<b>45</b>
Partners' obligations.....	47
Compliance with regulatory obligations .....	48
Disciplinary measures.....	49
Performance measurement .....	49
<b>Chapter 11: De-equitisation.....</b>	<b>51</b>
Provisions for expulsion from the partnership.....	52
<b>Chapter 12: Expulsion, retirement and dissolution.....</b>	<b>55</b>
Expulsion.....	55
Suspension.....	57
Retirement.....	59
Indemnities.....	63
Dissolution .....	64
<b>Chapter 13: Good faith, arbitration and mediation .....</b>	<b>67</b>
The duty of good faith.....	68
Preventing litigation.....	70
Indemnity and compensation .....	71
Arbitration .....	72
Mediation .....	73
<b>Part Two: Case Studies</b>	
<b>Preface .....</b>	<b>77</b>
<b>Case study 1: A defective business plan .....</b>	<b>79</b>
<b>Case study 2: Failure to draft for change.....</b>	<b>81</b>
<b>Case study 3: Failure to implement partnership clauses.....</b>	<b>83</b>
<b>Case study 4: Failure to notify insurers of claims and circumstances .....</b>	<b>87</b>
<b>Appendix: A deed of partnership.....</b>	<b>89</b>
<b>Index .....</b>	<b>111</b>

## Executive summary

SINCE THE first edition of this report, major changes have taken place in the law and in the regulations that apply to solicitors. From 6 October 2011, when the new Solicitors' Code of Conduct comes into force and when Alternative Business Structures (ABSs) are permitted, even greater changes will become inevitable.

Apart from the regulatory changes, the recession has had a significant impact on many firms, because both the volume and the profitability of work in many sectors have diminished. A significant number of firms have gone out of business and, although there is an upturn in some sectors of the market, many firms are viewing, with some trepidation, the increasing competition they are likely to face when the market for legal services opens up even further.

A surprising number of firms, particularly small ones, have managed to operate with an informal partnership arrangement, largely or exclusively governed by the default provisions of the Partnership Act 1890. Others may have entered into a formal partnership agreement, but have failed to update it, either because it did not seem necessary or because there was simply not enough management time to draft and to obtain partners' consent to a new agreement.

For some firms, particularly those which have been adversely affected by inadequacies in their partnership agreements, the decision has been made to convert to an LLP rather than to amend

the partnership structure to take account of today's requirements. However, many firms have come to realise that moving directly to an LLP is not always the best course.

Some firms have examined LLPs and have decided not to convert, whether because of the tendency for LLPs to become culturally more corporate, or because conversion creates considerable management upheaval. Some firms indeed consider that remaining a partnership conveys a more professional image than does a corporate or semi-corporate status.

Although the purpose of this report is to tackle the issues that arise for those remaining in partnership, a brief overview of the differences between partnerships and other forms of practice is offered. ABSs will be permitted after October 2011, but some forms of ABSs are more appropriate for some types of structures than others. The differences may influence the choice of structure, particularly for those firms which have not made a final decision as to which route to take. These topics are covered in Chapter 1.

Chapter 2 discusses the outside participation in law firms and, in particular, the consequences of ABSs. On 31 March 2011, the *Law Society Gazette* announced that the Law Society Council agreed by 54 votes to 16 that the SRA should apply to become a regulator of ABSs. Although many partnerships will not wish to become an ABS, some may already be legal disciplinary practices (LDPs) and existing LDPs with

non-lawyer managers will only continue to be treated as recognised bodies until 31 October 2012. By then, they will have to convert to ABSs. For this reason, an overview of how the ABS regime will operate may be useful.

Expansion has been difficult for partnerships recently, but at some point, firms need to attract new partners, even if it is only to replace the senior partners. Chapter 3 looks at how the structure of a firm may affect its attractiveness to new partners.

The new Solicitors' Code of Conduct imposes new management and reporting burdens on firms. It is therefore essential that the firm is managed in such a way as to avoid conflict with those new requirements. Chapter 4 advises on this and how management structures can be strengthened.

In an LLP, you either are or are not a member. With partnerships, the issue is far less clear cut. You can be a partner (even a secret partner), you can be an employee who is held out as a partner or, perhaps, you can be a salaried or non-equity partner. It is a matter of fact rather than of terminology as to which are regarded as partners, and it is important to note that someone who may, in law, not be a partner may be regarded by insurers or regulators as being a partner. Chapter 5 explains how you can ensure clarity on partner status in your partnership agreement.

The new Equality Act 2010 has not only consolidated existing discrimination law but has, in some areas, significantly expanded it. There are therefore more opportunities for the unwary or badly-managed firm to find itself on the receiving end of a discrimination claim whether, for example, from a partner who has been asked to retire or has been demoted because of age, or from a receptionist who has been shouted

at on a number of occasions by a client. Discrimination is not only a commercial issue for partnerships, but it is also a disciplinary one, and the obligation to operate a business in a way that ensures equality of opportunity and respect for diversity is now one of the ten principles listed in the new Solicitors' Code of Conduct. Chapter 6 covers how you can ensure that there is no provision in your partnership agreement which could constitute direct or indirect discrimination on a number of relatively new grounds.

Chapter 7 discusses the various ways in which profits and losses of a partnership can be dealt with to avoid discrimination and to suit the particular circumstances which may apply to different types of firms.

Chapter 8 tackles the difficult matter of trying to recruit and reward new and junior partners without alienating senior partners. This is particularly important if firms have to make the transition from a traditional pattern in which partners progressed on a lockstep system of an increasing share, perhaps with an annuity on retirement, to a merit-based system in which junior partners might appear to be disproportionately favoured having regard to their age and lack of long service and experience. Difficulties may also arise when partners are acquired from other firms, either because of their own merits or because they are able to bring with them an addition to the client base.

There is a general view among the public that partners in large City firms work extraordinary hours, can bill even in their sleep and burn themselves out at a young age. To a degree, this may be so but it is also the case that many firms find it difficult to recruit and manage their staff and partners, because the younger generation require a work and lifestyle balance which was neither sought by, nor available to,

the older generation. Chapter 9 considers what benefits should be made available and recorded in the partnership agreement, what should be made at the discretion of management, what benefits no longer have any practical function and how to avoid the haphazard giving of benefits which might lead to a claim for discrimination.

The new Solicitors' Code of Conduct, with its new overarching principles and its commitment to outcomes-based regulation, is a marked departure from the disciplinary rules which have governed firms in the past. The professed intention is to ensure that firms always achieve the results (now called outcomes) required by the principles, but it is left to the firms to decide how to do so. However, in the present draft, there is a contradiction in that the guidance notes (which, for the sake of simplicity and clarity, are now called 'indicative behaviours'), although not mandatory, may be taken into account in deciding whether there is a breach of principle. The SRA may impose conditions on practising certificates or Regulatory Settlement Agreements which are based on the indicative behaviours, rather than the outcomes or the principles. Another concern is that some professional insurers, although they may be forced to pay claimants under the minimum terms, have started to look more closely at whether, and when, circumstances which might be likely to lead to a claim have been reported to the insurer. They are taking steps to recover payments from firms where matters were not reported early enough. It is therefore becoming ever more essential that both partners and staff ensure compliance and prompt reporting of any concerns, and can be adequately disciplined should they fail to do so or commit any of the other offences which could spell trouble to the firm.

Chapter 10 therefore discusses supervision and disciplinary provisions.

While Chapter 11 discusses de-equitisation of partners, Chapter 12 examines expulsion, retirement and dissolution. This chapter also covers the concept of the anti-embarrassment clause which is beginning to make some noise in firms looking towards an ABS structure. An ABS structure may create capital value in the future but may have to dislodge long-serving partners in order to do so. This chapter addresses the implications of this issue and how it can be catered for in a partnership deed.

Partnerships are distinguished from ordinary businesses because they incorporate the duty of good faith between partners. The strains of today's legal regulations and commercial pressures have made this duty more important but less likely to exist in reality. Partners and whole departments are poached without any report being made to the management of the firm. Partners engage in internal litigation in order to be released, so that they can seek a more profitable future. These activities may be unedifying, but they are unfortunately more prevalent than they once were. Chapter 13 tackles these issues and how a partnership agreement can approach them. It also discusses how strategies may be adopted to avoid litigation.

Firms which have not looked at their agreements recently and now realise that something needs to be done before it is too late, may also wish to consider drafting an agreement which will be capable of allowing future developments in legislation, regulation and commercial reality to be accommodated, without having to go through the redrafting process and its associated negotiations on an ever more frequent basis. Chapter 14 discusses how



you can future proof your partnership agreement so as to avoid any unpleasant future consequences.

This report also features case studies and examples, as well as a sample partnership deed precedent which illustrates how the changes in legal services can be incorporated in the partnership agreement.

## About the author

NICHOLAS WRIGHT is chief executive of Wright Son & Pepper LLP, which has been in Gray's Inn, London for approximately 200 years. The firm's main areas of expertise are in commercial, private client, partnership and regulation law.

Nicholas has specialised in partnership and professional regulation for over 20 years and has been a member of the Solicitors' Assistance Scheme for most of that time. He has acted as receiver and assisted firms in professional difficulty in an orderly winding up of their activities at the request of the Law Society. He has acted for a number of substantial firms in dealing with regulatory issues, as well as dealing with drafting, restructuring issues and disputes, both for firms and for individual partners.

Nicholas is, with Victoria Wright, the editor of *Cordery on Legal Services* (Butterworths, 1995) which deals with practice structures. He is also the author of the first edition of *Partnership Agreements for Law Firms* (January 2008) and *LLP Conversion for Law Firms* (April 2010), published by the Ark Group.

## **Acknowledgements**

I WOULD like to thank my colleagues at Wright Son & Pepper LLP who assisted in this report, Olivia Burren at Travelers for advice on professional indemnity trends, my editor for being consistently cheerful and supportive when deadlines loomed and, above all, those in government and the regulatory bodies whose constant changes to the way legal services may be provided have made this edition necessary.