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Solving the Unfunded Pension Puzzle for Law Firm.

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Recent news reports have brought attention to a problem faced by many law firms, satisfying the promises made to retired partners, present and future, through unfunded pension plans. It has been suggested that these obligations will be too large a burden for some of those firms. The problem could be made less severe if partners nearing or past retirement age would volunteer to give up their rights, but that idea doesn't seem to have attracted much support. If law firms go out of business, those entitled to pension payments will be creditors, and their recovery of funds will be uncertain. There might be a less troublesome solution, involving the use of life insurance products, that could reduce or eliminate the problem if given enough time to carry it out.

How the Problem Began

For many years, self-employed individuals could not take advantage of the use of qualified retirement plans. It was not until 1962 that a modest level of contributions was permitted, and it took more years before parity was achieved with the contributions that could be made with respect to common law employees.

In part because of the lack of opportunity to make meaningful contributions to retirement plans on a tax-deferred basis, many law firms provided, in their partnership agreements, for payments to retired partners. There was no single formula used in all such cases, but they were often calculated as a percentage of a partner's final compensation, sometimes averaged over a few years. When the partner retired, he or she (nearly always he) would receive a pension payment for life, or at least for some period of years. Payments were made out of the law firm's current income, "off the top" so to speak, so they decreased the income available to current partners.

Some law firms took steps to defray the liability that was building up for retired partners. In some cases, this might take the form of a defined benefit pension plan. Because it was often possible to determine the unfunded liability that was being accrued under the partnership agreements, it was possible to construct a formula that would reduce that liability. The disadvantage of such an approach was that it required covering other partners or

employees of a law firm. Consequently, it could be an expensive solution to the problem. But if there were an independent objective of providing some level of retirement benefits to other partners and to employees, a defined benefit pension plan offered some relief, through current funding, to the unfunded pension problem. This could be especially useful in spreading out the future liability, if few partners had yet retired and begun collecting payments.

As this was happening, the rules for contributions to qualified retirement plans that covered self-employed persons were relaxed, eventually permitting the same level of contributions as in plans covering employees. Partners and law firms could now make substantial contributions toward their retirement, and most law firms adopted plans to achieve that end. Contributions could be made by those partners with the unfunded pension rights, but not those who had already retired. Some firms adopted a further offset to the unfunded pension obligation, measured by the value of the retirement accounts accumulated by partners. Of course, when partners make contributions to qualified retirement plans, they are really contributing their own money, because, if the contributions were not made, the result would be higher income for the partners. For that reason, some of those partners objected that they were defraying themselves the obligations the law firm had to them. Others realized that making current contributions added to the security of their retirement benefits. While this was happening, the younger partners were funding their own retirement, and in most cases they were not given the unfunded pension rights of the older partners. Understandably, the younger partners often felt that they were shouldering too great a burden, and an unfair one. In fact, younger partners could escape the burden by changing law firms, and some did, and this created a feeling of uncertainty within those law firms.

Another development added to the severity of this problem: Lawyers actually retired. In an earlier era, it appeared that lawyers never retired, that they practiced into their 70s or older. But more recently, lawyers have retired in their early-to-mid-60s. Obviously, this makes the problem even more severe.

A Possible Solution

At least one large law firm has recently adopted a program to defray the unfunded pension liability at a much reduced cost. This solution involves the use of life insurance products to create values that can be used to defray the pension obligations.

Life insurance sometimes causes suspicion, perhaps because it is often sold without consideration of its purpose, and because its many varieties and the complex nature of insurance selling illustrations make it confusing to non-experts, which most people are. But life insurance is just another financial product and it has the financial and tax characteristics that have been permitted by federal and state regulation. Life insurance is not a gamble you make with the insurance company. Particularly in the case of purchases of large numbers or policies, life insurance becomes an investment vehicle that provides for fairly predictable returns.

In one version of the life insurance funding plan, the law firm forms a trust and contributes money to it, which is used to purchase insurance on the lives of some partners. A study will be needed to determine which partners — it might be a combination of younger and older partners. The trust might borrow additional amounts from a bank, using the insurance policies as collateral, to pay the premiums. Over time, amounts are borrowed from the insurance polices and paid to retired partners, which can be done on a tax-free basis. As insured partners die, the trust collects the proceeds, which are received tax-free. The bank loan and the payments to retired partners are repaid with the insurance proceeds. The obligation to the retired partners can be paid at a fraction of the out-of-pocket costs of paying directly from law firm profits. A program of this type requires considerable analysis to determine the appropriate coverage amounts and attention must be paid to bank loan rates and insurance crediting rates.

The ongoing retirement of the baby boom generation has extended its effects to law firms, where the unfunded pension promises made many years ago are threatening the well-being of those firms. Depending on the size of the obligation, some firms will weather the storm, but others will be adversely affected by the departure of younger partners. The use of financial products such as life insurance, which have financial and tax attributes that can be beneficial for group purchases, may be a way to pay retirement obligations at a much reduced cost.

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