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A Return to Equity Partnerships?

The number of non-equity partners in law firms has expanded dramatically. In the US it has more than tripled in the largest firms over the past decade and increases of a similar nature are apparent in other jurisdictions. As we noted in an earlier Insight (Too Many Non-Equity Partners?) this trend has created challenges in many firms – ranging from under productivity of the non-equity group, blocking of opportunities for associates, and morale issues, among others. There is also a surprising employee mentality, rather than owner mentality, that settles in to some non-equity partnerships. Finally, the non-equity group is relatively highly compensated in most firms yet has no risk, and typically limited upside, based on firm performance.

As firms look ahead and adapt to a changing talent market and changing client expectations, they are starting to rethink the partnership structure. One of these changes is the adoption of limited equity partnerships for the many or all of the current non-equity group. The limited equity partnership is an elegant solution to many of the challenges of non-equity partnerships today, and one we have worked with a number of our law firm clients to implement. The idea of a limited equity partnership is that all or nearly all partners have a stake in the firm, albeit small initially, and share in the risk and rewards of the firm. While of course there are many variations on limited equity partnerships, key elements include:

- **A portion of compensation based on firm performance.** A typical structure might have a first year partner receiving 90% of compensation on a fixed, or salary, basis and 10% on a variable, or equity, basis. Typically the variable portion will be based on shares or units or a percentage, depending on how the firm sets compensation for full equity partners. As they progress, the majority of the increased compensation will come in the form of additional variable compensation so that compensation evolves to 50% fixed and 50% variable under a limited equity role before they advance to a fully variable basis.
- **Advancement, or decline, is a compensation committee or management decision.** The movement between limited equity and equity certainly has implications on compensation and capital but typically the decision to move a limited equity partner to full equity, or a partner from full equity to limited equity, is based on performance and is determined by the compensation committee or firm management and is not subject to a partner vote. Certainly the threshold decision in either direction is not taken lightly and is subject to additional scrutiny but ultimately is a compensation decision.
- **Partners contribute to capital.** A limited equity partner is generally expected to contribute capital to the firm. For many firms, it is on the equity portion of his/her compensation. For a partner with a 10% variable compensation portion, the capital contribution would be based only on that 10%. Other firms do a fixed contribution level for all limited equity partners, in some cases 50% of the equity requirement.
- **Partners have voting rights.** Most firms provide at least some voting rights to limited equity partners. These votes tend to be more significant than those that are provided to non-equity partners. Generally, voting in these systems is weighted, based on shares or units. Some firms will weight by category with full equity getting a full vote and limited equity partners getting half a vote. Some will carve out certain voting rights solely for full equity partners.

While making a change like this to a firm's partnership structure is not without challenges, the benefits can be significant. They include:

- **Partners are invested in firm performance.** When partners have at least a portion of income based on firm performance they have "skin in the game" and typically are more invested in the success of the firm. All partners with an equity stake share in at least some portion of the upside, and, to be fair, also share the risk when firm performance is less than expected. This risk/reward sharing moves non-equity partners away from an employee mentality and towards an owner mentality. The elimination or at least softening of the bright line between equity and non-equity can also increase engagement and morale for the non-equity group.
- **Partner performance and compensation can be more closely aligned.** By blurring the current lines between partner groups it allows more movement between the groups. Quite a few firms have anomalies in performance and

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compensation such that the bottom of the equity group includes partners not fully meeting the expectations of an equity partner, and yet there is reluctance to de-equitize. While the limited equity approach may still be seen as a demotion, the stronger link between compensation and performance will make it easier to make the right compensation and placement decisions. Similarly there are non-equity partners in some firms who are highly compensated yet have no risk and no investment in the firm. When partner risk and investment is linked directly to their compensation level these anomalies can be reduced.

- **Partnership admission decisions are more rigorous.** Because there is often not a partnership vote when a partner moves from limited equity to full equity, the structure requires more rigor at the initial partner vote. Some firms have not been as rigorous as they might be at this stage since they know there is another decision point down the road. While certainly some partners admitted in this way do succeed, others become performance issues that the firm is slow to address.
- **Increased capital investment in the firm.** While the ability to raise additional capital from limited equity partners is rarely, if ever, a primary motivator, it can be a benefit to the firm in other ways. First, it allows limited equity partners to start paying in capital at very low levels and build up as their equity increases. This mitigates the negative impact on cash flow that can sometimes occur for new equity partners who find that they need to pay significant amounts into firm capital. Second, capital investment is another component of having skin in the game and behaving like an owner of the firm. Despite these benefits, the requirement to pay in capital tends to be met with the most resistance or skepticism from non-equity partners when firms transition to limited equity structures.

Limited equity partnerships work best when the majority of the partners in the category are advancing at least part way up the ladder. While they may not be advancing at the same rate, and may plateau at different points, they need to be contributing at a partner level. For that reason not all current non-equity partners are suited to be, or aspire to be, limited equity partners. Firms who have adopted a limited equity structure have sometimes adopted or retained additional income partner and non-partner positions including fixed income partners, counsel and retired partners.

Limited equity partnerships may not be an appropriate option for every firm, but they do provide a viable alternative or supplement to non-equity partnerships that begins to solve the challenges that firms have experienced with those structures.

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