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What is the Meaning of Equity?

In law firms, the word *equity* has many meanings.

First and foremost, *equity* in law firm means the right to participate in the allocation of firm profits. In return for profit participation, equity partners in most firms are expected to invest in the firm and to contribute at very high levels - above that of other lawyers in the firm. Equity partners are expected to generate substantial client work and new business for the firm, manage and grow client relationships, perform billable work, train and mentor junior lawyers, build the firm's profile in the market, develop and implement the firm's strategy, and not least of all, contribute to management of the business of the firm.

In recent years, some firms have sought to be quite intentional and explicit in setting forth expectations for becoming and remaining an equity owner (for further discussion see Fairfax Insight: Tomorrow's Stars). However, others have lagged behind, hesitating to confront the partnership with this difficult conversation about contribution expectations. While some lucky firms have maintained homogeneity in partner contribution levels, others have observed a growing gap. Firms with a broad range in partner contribution find that a portion of equity partners truly engage and contribute at a high level to building and growing the firm, while others contribute in more discrete ways, as specialists or service lawyers helping to handle larger clients or matters.

When the contributions of equity partners become too uneven it can lead to tensions or a breakdown in the fabric of the partnership. In light of the fact that the word *equity* also means fairness, it is actually quite logical that a lack of partnership alignment on equity partnership contributions and expectations would lead to a sense of inequity.

A number of firms have attempted to solve these tensions through partner compensation allocations, under the theory that a firm can address a wide disparity in partner contributions by simply paying some partners less. It is true that many well-run firms pay for performance, and therefore differences in contribution level are reflected in compensation. Firms observe benefits associated with 'stretching' compensation to some degree. By creating a wider gap between the highest and lowest paid equity partner, firms are able to reward and retain top performers, attract high performing laterals, and recognize superior business development capabilities, which creates clearer incentives around business generation and promotes revenue growth. Without some degree of stretching, firms would likely underpay top performers or create disincentives for future stars looking to move up in the system.

However, the key question for discussion is whether or not firms can solve for material contribution gaps through compensation alone, or whether a better solution would be to address partner *equity*. Firms which believe that they can address material performance differences through compensation argue that by paying partners less they avoid the discomfort of setting baseline performance expectations or counseling partners not meeting some minimum performance standard.

Unfortunately, though, this strategy rarely works. Even at reduced compensation levels, the profit margin on equity partners falling below a baseline standard for total contribution can be quite low or negative. Feelings of inequity also cause issues beyond compensation. Those not meeting equity standards still benefit from a disproportionate share of voting rights relative to their contributions, and these individuals may directly or indirectly influence the direction of the law firm in ways which are misaligned with the goals of high performing equity partners.

So, if compensation alone does not solve the problem, how can firms seek to retain skilled lawyers with materially different levels of performance and contribution?

Once again, we must turn to the word *equity*. The Latin origin of the word *equity* is equal. While it is not realistic to expect all equity partners to contribute in equal amounts, law firms which reach agreement on a reasonable range for total contributions among equity partners tend to alleviate contribution related tensions. This, in combination with the creation of a partial or limited equity role, allows other high value partners to contribute at more variable levels and still participate in the firm's profit pool (albeit on a more limited basis), while generating greater consistency and an increased sense in fairness in full equity partner contributions.

Full Equity: Full equity is best defined as the owners of the business who have the most 'skin in the game' – in terms of a sizeable capital contribution, at risk compensation, and a high degree of total contribution. Full equity partner compensation is tied directly to firm profits, and the expectations for this group are often the highest expectations set within the firm. This group truly is taking on a disproportionate share of the load in growing and building the firm. While most firms vote on only a limited number of issues, full equity partners have a full vote (either per capita or less frequently, weighted based on compensation), and collectively, this group heavily shapes the strategy and direction of the firm.

Partial Equity: Under a partial or limited equity model, partial equity partners still contribute at a partner level – meaning that these are not low performers or fungible lawyers. However, partial equity partners do not contribute at a level which is as consistently high as that of the full equity group. These lawyers may be high value specialists, or individuals with lower client generation. Some firms reserve the partial equity category for rising star lawyers who are on the path to equity but are still building their book of business to a level which will meet equity standards. Other firms use the partial equity partner role more broadly, including mid-career lawyers with a smaller book of business but solid personal production, or highly productive service partners with limited business generation.

Partial equity partners have a limited ownership stake in the firm, but still share in the risk and rewards of the firm. This serves to balance compensation risk for partial equity partners, as 51% or more of compensation is paid on a fixed or salary basis, with typically 10-49% paid on a variable, or equity basis, tied to both individual and firm performance results. Partial equity partners also contribute capital to the firm, often determined based on the equity portion of a partner's compensation. These partners typically also have weighted voting rights based on their percentage of compensation at risk, or for select categories of partnership decisions.

Partial equity models have gained popularity in law firms over the past decade, and we see a growing number of firms adopting a partial equity model. (For further discussion, see Fairfax Insight: A Return to Equity Partnerships?). Depending on the use of the model, some firms find it particularly valuable as a tool for helping partners historically treated as non-equities to feel more invested in the firm and to allow them more time to build their book of business to equity standards. In other firms, the primary benefit of the delineation between full and partial equity is to align partner understanding of the meaning of equity and to alleviate the tension inherent in wide disparities in partner performance and total contribution.

Equity in law firms carries many meanings. The key to promoting a sense of fairness in partnership thinking about equity is to better define the expectations of full equity owners, while creating space for those high value partners contributing in more individualized ways.

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