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Evolving Partner Structure

The number of U.S. law firms with true single tier partnerships continues to decline as more firms create an income partner role withing their partnership structure. Among the AmLaw 200 firms, only 27 firms still identify as single tier partnerships, and at least 2 of those have recently reported that they are adding or are considering adding a non-equity tier. Forty-six percent of all AmLaw 200 partners are now non-equity partners.

As more firms move away from a single tier partnership model, many firms have also considered adaptations to the traditional two tier salaried income and full equity partner model. As the percentage of income partners grows within firms, it is time for firms to evaluate their partnership structure and test whether their current structures are appropriate in light of talent and market pressures.

Why Consider Change?

As we have written before, the rapid growth of the non-equity tier has resulted in some challenges for 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 into some non-equity partnerships. And even in some equity partnerships, there can be a wide range of commitment to the firm, creating internal tensions.

In addition to these challenges, there are market forces now contributing to a heightened need to consider changes to the partner structure. These include:

- The need to pay top producing partners competitively: Given the competition for talent and the mobility in the talent market, firms need to think about which partners should truly share in the upside (and downside) of firm performance. For many firms, this is increasingly a smaller proportion of the partners in the firm.
- Recognition of different contributions to the firm: In large firms in particular, partners can contribute to the firm in different ways, such as by offering a distinct subject matter expertise, or significant client relationship management skillset.
- The demand for flexibility and different career paths: As generations change, lawyers may be looking for more balance and not want to, or be able to, make the significant commitment to the firm that may be required for a full equity partner.

Beyond these challenges with the traditional model, there is also a talent retention issue arising among high performing income partners. Historically, business generation was the predominant dividing line between income and equity partners. Today, we see many large firms raising the bar for equity partner admission, with materially higher expectations for business development success. As more firms elevate equity business generation requirements, one outcome is a relatively high performing group of income partners at the top of the ladder who, even a few years ago, would have been promoted to equity. Due to their higher performance and contribution level, the traditional salaried income partner role is unlikely to be a role in which these individuals feel engaged, motivated, and want to remain with the firm.

Options to Consider

A number of firms have adopted limited or variable equity partnerships. 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 those partners have a stake in the firm, albeit small initially, and share in the risk and rewards of the firm. In some firms this group may be a small group in between income partners and full equity while in others it may be the majority of the formerly income partner group.

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 partners progress in their careers and contribution levels, most 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/full equity basis.

- 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 use a fixed contribution level as the capital requirement 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 weight voting by category with full equity getting a full vote and limited equity partners getting half a vote. Most firms carve out certain voting rights solely for full equity partners.

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, nor aspire to be, limited equity partners. Firms who have adopted a limited equity structure have often adopted or retained additional income partner and non-partner positions.

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, the structure allows more movement between the groups. Quite a few firms have anomalies in performance and 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. The limited equity model can make movement between full and limited equity an easier decision.
- The upside of strong firm financial performance can be more fairly allocated to those meriting additional compensation. The strong financial performance of firms in the last few years, particularly those with a prospective point or unit based system, has resulted in an uplift to partner compensation that may be disproportionate to the contributions of some partners. While a rising tide should indeed benefit all partners, it should most benefit the partners who drove the growth. Being able to share a portion of the upside with limited equity partners (10-50% of their compensation as opposed to 100%) may more fairly recognize their level of contribution and risk.
- More flexibility to recognize different contributions. Retention of talent remains a key issue at firms. The limited equity model can provide a path for partners who may not want to or be able to advance to full equity partnership, yet still offer high value contributions as members of the firm. The income partner model may work for some, but the limited equity model can be a better way to engage and retain high performing partners who want a different path.

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 and may help to solve some of the challenges that firms have experienced with traditional partnership structures.

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