Benefits and Drawbacks of Two Tier Partnerships in Law Firms

Summary: What are the benefits and drawbacks of creating a non-equity career path? What are successful firms doing to manage non-equity partnership opportunities?

A large number of other firms have moved to a two-tier structure but continue to apply an “up or out” policy, forcing all non-equity partners to ultimately meet the criteria required of equity partnership or to find a new law firm. Like single-tier firms, these firms limit long-term opportunities for strong lawyers who lack business development skills or equity partnership interests.

In light of today’s heavy competition for talent and sky-high profit expectations, a growing number of our clients are asking: How and why should we deal with lawyers who do not have the ability or desire to become owners of the firm? What are the benefits and drawbacks of creating a non-equity career path? What are successful firms doing to effectively manage non-equity partnership opportunities?

Defining Two-Tier Partnership Structures

A two-tier structure consists of two differing types of partner positions and related roles and responsibilities: equity partners and income partners. The primary difference between the positions is that equity partners:

- Make a capital contribution;
- Participate directly in the profits of the firm;
- Are liable for the debts of the firm; and
- Exercise ultimate control over the policies and direction of the firm.
By contrast, income partners do not make a capital contribution, participate only indirectly in the profits of the firm (usually through a salary and bonus potential), are often indemnified by the equity partners, and generally have only limited voting rights.

The general purpose for establishing a two-tier structure is to create a partner-type position whereby the firm can retain lawyers who make a valuable contribution to the firm but who are not currently, or in some cases ever, willing or able to meet all the requirements of equity partnership. In doing so, both the firm and the associate are offered an alternative to unnecessarily terminating a profitable and productive working relationship.

For many successful firms, the adoption of a two-tier structure effectively eliminates the mandated “up or out” policy. Firms that adopt a tiered structure but continue to apply a forced up or out policy lose many of the benefits associated with two tiers. They also risk engendering frustration and/or distrust from associates and non-equities, who see this as merely subterfuge for prolonging the equity partner career track.

There is also some justifiable perception that tiered structures are simply a means for firms to improve their Profit Per Equity Partner rankings. While that may be true for some firms, the large majority adopt a two-tier structure in recognition of radical changes overtaking the profession:

• As the profession becomes increasingly competitive, it should become harder – not easier – to become an owner in a successful law firm.
• A growing number of talented lawyers are not currently interested in becoming an equity partner, but wish to preserve their long-term option to make that commitment.

Despite assertions by many firms that they can accomplish the benefits of a two-tier structure simply by controlling compensation, few firms have succeeded at this. Instead such firms often make too many associates into equity partners and/or allow the incomes of qualified technicians to vastly exceed market value. Only through an explicit two-tier structure can firms effectively control the compensation of such individuals and ensure they don’t dilute the decision-making authority of the firm.
Non-Equity Career Paths

By offering an alternative career path to high-value lawyers, firms recognize that lawyers develop at different paces and that not all lawyers may aspire to equity ownership. Alternative career paths offer lifestyle choices and simultaneously provide greater flexibility in a profession known for rigidity.

Beyond the benefits of an alternative career path, a two-tier partnership structure:

1. Helps to improve a firm’s economic viability and market competitiveness: By maintaining higher equity partnership standards and associated business development expectations, firms ensure that those in equity partner roles are fully committed to investing what it takes to grow profitability. Additionally, although income partners are well compensated, most firms maintain a clear gap between income and equity compensation, so that the returns to the equity partners reflect their extra commitment and contributions to the success of the firm.

2. Serves to redefine the roles and responsibilities of “partnership” in a more rigorous way: Through the process of adopting a two-tier structure, firms are forced to define equity and non-equity partnership more clearly. In particular, firms take a hard look at the capital and other contributions required of equity owners of the firm. Sometimes firms find that years of complacency or laissez faire management have allowed deterioration in the level of these contributions.

3. Eases the personnel challenges and expenses associated with an up-or-out system: As many firms are well aware, there are innumerable costs associated with forcing out a high quality lawyer simply because he or she lacks some of the skills or ambition required to become an equity partner. In many cases, such lawyers prove to be valuable assets to a firm in non-equity roles, acting as substantive experts, assisting in training associates, or managing quality control.

4. Enables lawyers to maintain ‘partner’ status with the external community: This is particularly valuable in cases of senior, experienced lawyers who have deep substantive expertise but may lack business development capabilities. Partnership status allows such individuals to present themselves to clients and the public as senior members of the firm, while reducing partnership obligations and expectations that they may be unable to meet.
**Drawbacks: Real and Spurious**

Many firms focus instead on two alleged drawbacks of two-tier structures. These drawbacks include one genuine pitfall but also one nonissue:

1. **Allows management to avoid making tough decisions:** In the worst examples of two-tier law firms, we typically see non-equity partner positions become the dumping grounds for lawyers with serious weaknesses, most often relating to significant personality problems or quality issues. These firms, in an effort to avoid a difficult conversation, fail to realize that de-equitizing problem partners is rarely the right solution. In our experience, at least half of all firms utilizing a two-tier structure have fallen into this trap.

2. **Creates a longer equity partnership track, allegedly impairing recruitment and retention:** Some firms believe that a lengthened career track and prerequisite income partnership status inhibit their ability to compete for top-tier talent. This is not a meaningful issue. The majority of firms in the middle market and above now utilize two-tier structures, creating fewer opportunities for associates to seek comparable firms with a shorter career track.

Additionally, the rare individual who will leave a firm or turn down an associate position merely because he or she can become an equity owner in another firm faster typically has an overwhelming tendency to be a lawyer with sole practitioner habits and a lack of interest in the overall success of the firm. Interestingly, the most talented lawyers tend to be the strongest advocates of a two-tier ownership structure, as they believe they are the long-term beneficiaries of its attributes.

Well-managed two-tier law firms alleviate both of these issues by ensuring clarity in partnership criteria, communicating regularly and openly with both partners and associates about the firm’s structure and partnership requirements, and holding partners accountable for meeting equity and non-equity partnership expectations. Additionally, by carefully considering and evaluating the unique career path opportunities and developmental needs of individual lawyers, firms ensure that their highest achievers receive appropriate advancement opportunities and that those with weaknesses or limitations are effectively coached and mentored.
Conclusion

Two-tier ownership structures enable firms to deal openly and effectively with lawyers pursuing a non-equity career path. In a well-managed firm, the benefits associated with retaining high-value lawyers through such a structure far outweigh potential drawbacks.