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So Many Tiers

Why firms have two-tier partnerships and how to pay the second tier.

Are two partnership tiers better than one? Nearly 80 percent of the Am Law 200 seem to think so, according to the most recent survey by *The American Lawyer.* In most of these firms, equity partners receive a designated share of firm profits while second-tier partners are paid on a basis unrelated to overall firm profit levels. But two-tier structures have caught on at smaller firms as well, with about half of all firms in the 20-100 lawyer range reporting this approach to partner compensation, according to a 2002 report by the *Boston Business Journal*. There's no question about it: The two-tier partnership structure is here to stay.

Why firms adopt tiers

The justifications for a two-tier partnership structure are numerous:

Equity Status for Strongest Performers Only. Firms with a two-tier structure reserve full-equity status for partners who make the most significant contribution to profitability. Those whose contributions are deemed less vital are relegated to the second tier.

Transition Status. Second-tier partner status provides a convenient transition for partners either new to the firm or newly elevated from the associate ranks, or for former equity partners whose contribution no longer justifies equity participation. Second-tier status also provides a permanent resting place for lawyers who don't meet equity-partner performance standards but are important firm resources nonetheless, often because they offer a unique technical proficiency to clients. It's often said that second-tier partners are like passengers on an elevator: some are on the way up, some are on the way down, and some are standing still.

Client Relations. Most two-tier firms hold all partners out to the world as partners without distinction between full-equity and the second tier. By easing admission to partner status, a two-tier structure enables a firm to present a higher percentage of its professional workforce as partners. This facilitates higher billing rates and strengthens relationships with those clients who may only want to work with partners.

The Numbers Game. And finally, by limiting equity partner status to the firm's most productive and highest-paid partners, a two-tier structure enables a firm to report higher full-equity profits per partner than if it were a single-tier firm — even though average compensation for all partners is the same in either a one-tier or two-tier structure.

Many large firms believe that higher publicly reported profits enhance their image both internally and externally and facilitate lateral partner and associate recruitment. This can cut the other way, however, with clients who are offended by the profit levels reported at their outside law firms.

But there are key disadvantages that firm leaders must consider:

Concentration of Risk. While the benefits of equity partnership in a two-tier firm are shared by fewer partners than if it were operating in a single-tier structure, the burdens of partnership — leases, bank borrowings, malpractice risk, capital contributions, and the like — are shared by fewer people, too.

Cultural Divisions. Two-tier systems often lead to divisions within firms, creating so-called "second-class citizens." At one firm with which I'm familiar, some second-tier partners jokingly refer to themselves as "residents of the Class B ghetto."

Lack of Incentives. In a two-tier structure — where second-tier partners have no profit-sharing interest — there is no direct financial incentive for such partners to

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contribute to firmwide profitability.

How to pay the second tier

After weighing the pros and cons, most firms conclude that a two-tier structure is in its best long-term interests. But after adopting a two-tier structure, how do you pay the second tier? What system works best and will provide the greatest benefit to both the firm and the non-equity or partial-equity second tier?

Some firms pay a straight salary; some follow a formula (often with a fixed base amount); and some pay a fixed amount plus a share of firm profits. Almost all firms have bonus plans that supplement base pay, with bonuses tending to represent up to one-third of a second-tier partner's total compensation package. I'll describe each method briefly and tell you which one I think works best, and why.

Salary. The most straightforward way to compensate second-tier partners is to pay them a base salary. At firms that use this method, second-tier partners are generally treated as employees for tax purposes and may or may not have voting rights. Their benefits are usually paid by the firm.

The principal advantages of a salary-based system for second-tier partners are simplicity and predictability — for both the firm and the second-tier partners. But those characteristics can also work to the firm's disadvantage. If second-tier partners are paid like employees, they'll tend to behave like employees rather than owners. They won't have the same financial interest as equity partners in the firm's overall performance. And even though many second-tier partners — and associates and support staff, too — care deeply about the firms they work for, they may not go the extra mile that equity partners will to advance the firm's interests.

Formula. Some two-tier firms compensate second-tier partners principally according to formulas based on objective measures of individual performance such as billable hours, work-attorney collections, and business originations. Often, these firms also pay second-tier partners a base salary, but the formula portion usually generates at least half of the partner's overall compensation.

While formula-based systems encourage partners to work long hours, originate new business, or otherwise behave in a manner that will boost their pay, the disadvantage is that these systems encourage partners to act only in their own interest. Formulaic systems encourage hoarding, heavy-penciling, and other forms of selfish behavior while discouraging mentoring, marketing, delegation to junior lawyers, and other intangibles that can benefit the firm. In my mind, the disadvantages of formulaic systems far outweigh the advantages.

Fixed amount, plus share of firm profits (partial-equity). In partial-equity systems, second-tier partners receive both (1) a fixed base salary amount, and (2) a share of firm profits. Firms use partial-equity systems because they provide the second tier with a "piece of the action," i.e., a direct interest in overall firm profitability. Most firms believe this is a desirable result.

There is no hard-and-fast rule as to how much of a second-tier partner's base income should be paid in the form of a fixed amount and how much should consist of the equity share. By *The American Lawyer*'s definition, the share of firm profits must represent less than 50 percent of the second-tier partner's compensation. My own view is that the equity piece should represent about one-fourth of the expected total — enough to be meaningful, but not enough to blur the distinction between equity partners and the second tier.

The principal advantage of a partial-equity system is that the profit-sharing component encourages second-tier partners to engage in behavior that benefits the firm rather than behavior that benefits only themselves, leading to promotion of teamwork and firm unity. And because most partial-equity firms require second-tier partners to make modest capital contributions in proportion to their profit participations — and may grant them voting rights as well — partial-equity partners generally have stronger ties to their firms than partner who are paid on a salary or formula basis.

In my mind, these advantages are persuasive and make partial-equity systems the best way to compensate second-tier partners.

Finally, with respect to compensation, keep in mind two key points:

First, there is no right or wrong way to compensate second-tier partners. What matters most is that a substantial majority of the firm's partners — both equity and second-tier — believes that the compensation system is both fundamentally sound and fairly implemented.

Second, compensation is the most important tool available to influence partner behavior. Firms get what they pay for. Formula-based compensation schemes that reward only objective measures of performance tend to encourage conduct that benefits partners as individuals rather than behavior that benefits the firm as a whole. In my experience, the most successful firms have compensation schemes that reward not only objective criteria but also subjective factors — such as, teamwork, cross-selling, leveraging, mentoring, citizenship, technical proficiency and external activities that benefit the firm.

That said, the most important factor is whether partners believe that the system is fair. Only you and the partners at your firm can make that judgment. LFI

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