



## PRACTICE

# Equity vs non-equity partners

## What are best practices?

BY **EMILY MORROW**

SUCCESSION PLANNING IS A COMPELLING ISSUE FOR THE New Zealand legal community as many 'baby boomer' lawyers are, or soon will be, retiring. This is good and bad news. The good news is that there are likely to be opportunities for younger lawyers to become partners. The bad news is there could be insufficient lawyers to fill these positions, particularly outside of the main urban areas.

Successful succession planning is closely associated with bringing lawyers in as new partners, whether through internal promotion or lateral hires. Whether or not to have a non-equity partner (NEP) status available in a firm is an important consideration in this regard. Firms often struggle with the advantages and disadvantages of doing so and the answers are not always self-evident.

Consider the following: Brown & Baker is a fictitious law firm located in a smaller regional centre in New Zealand. It currently has eight lawyers, five of whom are full parity equity partners (EPs) and three of whom are over 60. The three staff lawyers have between two and five years' experience. Brown & Baker's practice has been growing steadily as smaller regional firms close due to the retirement of older practitioners whose clients have migrated to Brown & Baker.

The managing partner explained there were two sources of new partners for the firm; existing solicitors in the firm who had the potential to become partners and more senior lateral hires. Despite being a regional market leader, Brown & Baker has struggled to attract and retain talent because many lawyers prefer to live in larger urban areas. Accordingly, the firm needs to make the pathway to partnership particularly appealing.

Brown & Baker has never had NEPs and all EPs have been full parity partners. The partners have differing views on whether they should have NEPs. Some welcome the idea as a way of bringing talent into the firm without the significant commitments, on both sides, of equity partnership. Others are concerned it would result in relatively few EPs carrying the full personal liability for the firm and the creation of a permanent 'second class partnership status'. What should the fictional firm do?

### The pros and cons of NEPs

NEP status can be an excellent way to gradually bring

in new partners with less of a financial commitment, while creating a status for individuals who will benefit from having a partnership title. NEPs typically fall into one of two categories; those for whom NEP status is a clear step towards equity partnership and those who will likely never become EPs. I tend to think it is a better practice to use NEP status in the former rather than the latter context. Having long-term NEPs can create structural problems for a firm which can be problematic over time. On the other hand, it can work well to have NEPs 'in waiting' who spend several years as such before entering into equity, often in a lock-step arrangement.

One of the disadvantages of NEPs (from the perspective of EPs), is that NEPs do not share in the firm's full financial liability in the same way that EPs do. This can consolidate liability amongst a relatively few EPs and potentially create a disincentive to move into a full equity position. Why buy the cow if you can just buy the milk? Assuming EPs earn more than NEPs, the income differential must be large enough to compensate for these liability concerns.

### The financial aspects of NEP status

Assuming NEP status is used as a segue to full equity, a firm should optimise that process. For example, some firms are very transparent with their NEPs as to the firm's finances, EP compensation, expense allocation and the like, whereas others are quite non-disclosing. Some firms will invite their NEPs

to partnership meetings but excuse them from all financial discussions. Frequently, it is the practice manager who is tasked with either 'hiding' the financials or disclosing them, a situation that can prove to be fraught for all involved.

My preference is for full or close to full financial disclosure with NEPs. I realise this can create friction, particularly over compensation issues. However, if this is handled in a fair and appropriate way, both for EPs and NEPs, then, at least in theory, there should be nothing to hide. If there is, a firm would be well advised to revisit its partner compensation structure.

If an NEP comes in as a senior lateral hire, that individual will want to see the firm's finances and understand the partner compensation system, etc before joining the firm. In that case, I think there needs to be full disclosure. If an NEP comes through the ranks, then I suppose it is more acceptable to share less information with him/her, and there may be less of an expectation to do so. Again, however, I think it is a better practice to be open about the finances.

Another instance in which NEP status can be helpful, is when there is considerable disparity between the billings and business development of partners within a firm. For example, if a partner is less productive financially and brings in less new business, due, for example, to the need to devote more time to family or other 'outside' interests, moving into NEP status can be an excellent solution. Without that, friction can develop within the partnership due





to perceived inequities in billings and/or expense allocation amongst partners. Stepping out of equity can mitigate these contentious issues and keep a partnership together for the long term benefit of the firm as a whole.

### Integration of NEPs into the partnership

To set the stage for a smooth transition from NEP to EP status over time, I suggest firms do the following:

- Have NEPs attend all partner meetings,
- Encourage NEPs to assume firm governance/leadership roles,
- Invite NEPs to all partners' off-site planning retreats and social events,
- Provide 'soft skills' training to NEPs to expedite their readiness for equity,
- Equalise the playing field between equity and NEPs internally and externally,
- Encourage NEPs to participate actively in partner meetings and vote on all matters except uniquely equity issues.

### Movement from NEP to EP status

Generally, I have found NEP status works best as a transitional role, rather than a permanent position for a lawyer. Firms will often, however,

encourage a lawyer who lacks business development, leadership and/or management abilities but who is a good, 'solid' lawyer to remain indefinitely as an NEP. Although this can work well, it can also be problematic. For such an arrangement to succeed long term, there must be complete alignment between the individual's and the firm's personal and professional goals. It can be a better practice to encourage an NEP who clearly will never move into equity to find a more appropriate position in another setting.

### Should a firm continue to have NEPs?

If a firm has had NEPs historically, it may be appropriate to consider whether that structure remains appropriate. For example, a firm that has made NEPs part of its succession plan may later find it no longer needs to do so to attract/cultivate/retain new EPs. Frequently, the most robust firms only have EPs, albeit ones with unequal equity interests. Eliminating NEP status may require rethinking whether a parity partnership model is the best way to handle partner compensation. That said, it may be worth moving away from parity and towards percentage interests that reflect individual EP contributions rather than having long term NEPs.

Whether or not to have NEPs

is a matter of judgement and the decision will vary from firm to firm. However, I do think there are some arrangements that will likely withstand the test of time better than others. ■

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