Freshfields' Non-Share Home Turf Handicap

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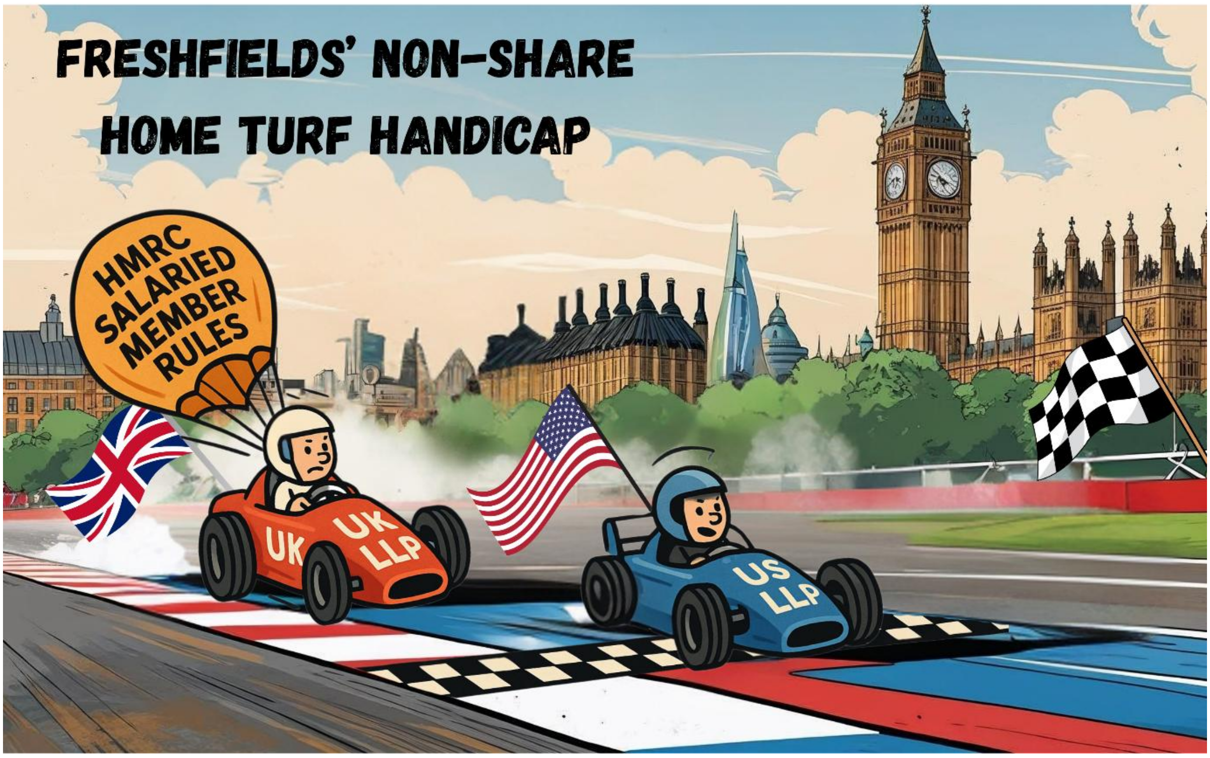

The "Kirklandisation" of Big Law; yet more of US Big Law's holdouts drop all equity partnerships

A Stateside phenomenon, which has begun to impact the UK partner recruitment market over the last few years, has been the (initially clandestine and selective) abandonment by uber conservative US law firms of their once sacrosanct all equity partnership models. Over the past eighteen months this trend has accelerated with elite New York firms, such as **Cleary Gottlieb**, **Cravath**, and **Paul Weiss** overtly adopting a non-share tier of partnership. In the past two months, some of the final holdouts, such as **Debevoise & Plimpton**, have seemingly bowed to the inevitable and have either announced plans to adopt a non-share class of partnership, or are actively considering it.

The changes are an offensive/defensive play forced on the US elite as a direct result of an increasingly widespread recruitment tactic, first used to phenomenal success by that arch-disrupter **Kirkland & Ellis** in its more than decade-long rapid expansion.

Whilst all-equity partnerships convey many advantages to elite law firms, in a world where most competitors have converted to two-tier partnerships, they are structurally inflexible and, due to the high bar to entry, make rapid partner expansion problematic and prohibitively expensive; particularly when hiring teams. By contrast having a non-share partnership cadre enables a firm to dangle the carrot of day-one partnership to talented senior associates from rivals at limited cost. It can also help

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(partially) inoculate a law firm against losing its best senior non-partners by giving those lawyers the partnership badge without overly diluting profits per equity partner. Indeed, the savings made have enabled law firms to stretch their equity spread to hire (and retain) increasingly expensive full equity laterals; this phenomenon is in no small part behind the rise of the $20 million p/a lateral.

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With virtually every elite US law firm now converting to a two-tier partnership structure, it has been widely reported that **Freshfields**, the most successful of the UK founded law firms Stateside, is actively considering following suit. Indeed, in order to remain competitive in the US recruitment market, this is now likely inevitable.

Freshfields' (and all UK LLP's) are disadvantaged in their home market

Unhappily for Freshfields, the obscure workings of UK tax law—specifically the Salaried Member Rules, actively disadvantage UK-structured LLPs (limited liability partnerships) compared to US LLPs. The Salaried Member Rules are there, in broad terms, to treat 'fixed share' partners as employees and tax them as such, which is a higher tax burden than for true 'equity' partners. This means that if Freshfields introduces a non-equity tier to its partnership, it will face higher like-for-like costs and an increased administrative burden in its home market compared to several of its US rivals in London. This would be the case even if Freshfields were to hire the same lawyer on exactly the same headline compensation. This paradoxical "home turf disadvantage", which applies to all UK LLPs* arises because the Salaried Member Rules do not apply to foreign LLPs (which include US law firm LLPs).

Unfortunately, for UK law firms, the Salaried Member Rules mean that UK law firms are required to pay an additional 15% in Employer's National Insurance Contributions on the compensation of all their non-equity partners (not to mention statutory pensions contributions**) – taxes which many US law firms in the UK avoid simply by virtue of being foreign LLPs.

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Whilst UK taxpayers may feel aggrieved at being denied scores of millions of pounds in revenue from all those foreign LLPs, in practice, the tax take from the UK equivalents is not significant. This is because, many UK law firms stay on the right side of the Salaried Member Rules through a series of not-too-expensive, yet painful-to-administer, statutory "workarounds" which create, at least the illusion of, real partnership for their fixed-share partners and so legitimately avoid HMRC (the UK's revenue service) triggering a finding of "disguised employment".

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These statutory exemptions involve a combination of either: (i) tying a proportion of a given partner's overall compensation (no less than 20%) to the financial performance of the firm; (ii) (often) funding an individual partner's capital contributions (their "skin in the game"); and (iii) providing the partner with at least the semblance of influence over the law firm's business, for example, by granting them limited voting rights.

Fortunately for Freshfields, and its UK peers, the majority of US law firms in London have subsidiaries which are structured as UK LLPs and so are subject to exactly the same Salaried Member Rules as UK law firms. Nevertheless, for those US firms that are not—which less-fortunately for Freshfields includes its most bitter rival—there is an advantage in being exempt from the Salaried Member Rules.

The advantage of foreign LLPs in the UK market extends beyond a mere administrative cost fillip. In today's fiercely competitive recruitment landscape—where even marginal gains can prove decisive—the ability of a law firm to offer an incoming non-share partner an "all-in" compensation of, say, £500,000 without requiring a capital contribution of at least £100,000 is a significant edge in the war for talent. This is especially pertinent given that recent law firm collapses have shown there is a non-negligible risk of losing such contributions entirely. That risk is only likely to grow with the exponential rise of law firm "star culture," which has rendered elite firms increasingly structurally fragile.

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"In UK LLP stepped in so far …"

So, if being structured as a US LLP in the UK is such an advantage for US law firms in London, why were so many structured as UK LLPs in the first place? And why, don't more US law firms in London convert back to US LLPs? – after all, with the exception of **Jones Day**, they will almost certainly be structured as US LLPs at home.

The answer to the first question is that, for most US law firms, the decision to set up in London as a UK LLP would have been made before the Salaried Member Rules came into force (April 2014), so the rules were not factored in. Indeed, many US firms were initially set up as small outposts staffed by Stateside partners on rotation in London solely to practice US law on European deals. At the time, many US firms likely had zero intention of ever launching an English law practice. As such, had there even been some minor tax or administrative advantage for the US subsidiary to be structured as a UK LLP, it may not have been significant enough to warrant the confusion of an additional legal entity. Regardless, with hindsight, those US firms which remained as US LLPs seemingly got lucky!

The answer to the second question is that any structural or legal entity change made on the basis of reducing tax might trigger targeted anti-avoidance tax rules.

And it's probably going to get (slightly) worse …

Over the past two years, the (often covert) adoption of two-tier partnerships by elite US law firms has started to impact the overall number of partner hires in London. Scores of lawyers have already joined US law firms which under, their old all-equity structures simply could not have hired them as day-one partners. The seemingly final abandonment of all equity partnerships by virtually the entirety of US Big Law's holdouts is likely to manifest itself in more day-one partner hires at many of these firms in London. Unfortunately for UK LLPs (Freshfields and most US law firms included), it is probable that at least some of these new two-tier partnerships will be structured as US LLPs in London. Them's the breaks!

* Alone amongst UK founded Big Law firms **Slaughter and May** is not structured as an LLP.
** UK employers are legally required to make pension contributions for eligible employees under the automatic enrolment rules established by the Pensions Act 2008.

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