

***SELECTED ISSUES IN THE CONVERSION OF AN
EMPLOYEE TO A PARTNER/MEMBER***

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1. OVERVIEW.

“Employees are a company's greatest asset - they're your competitive advantage. You want to attract and retain the best; provide them with encouragement, stimulus, and make them feel that they are an integral part of the company's mission.” Anne Mulcahy

Successful businesses have always understood that there is value in retaining good employees. This value shows up as a tangible cost when you examine the time and money necessary to replace employees. According to the Center for American Progress, it costs roughly 20% of an employee's salary to replace a lost employee. Jobs that are very complex and require higher levels of education and specialized training tend to have even higher turnover costs. Very highly paid jobs and those at the senior or executive levels can cost a company even more.

The value of retaining good employees also shows up as an intangible benefit through the retention of knowledge and consistency of performance. It is well documented that the longer employees stay at the job, the more skills they acquire and the greater contribution they can make to the daily operations of the company. When you lose good employees you lose ideas, talents and institutional knowledge.

There are times in the life of each company where an employee may become so integral to its operations and success that it makes sense for them to move from the ranks of employee to “owner.” To the employer, this may mean a greater more secure commitment from a key person in the business operations. To the employee, this may mean the potential for greater economic reward.

The purpose of this outline is to highlight some selected issues you may want to consider when converting an employee to a partner of a partnership or member of a limited liability company.

For ease of presentation, as we discuss this topic we will generally refer to the employee who has been or will be elevated to the level of “owner” as the “service partner.” We will also discuss these issues in the context of how they may apply to partnerships, limited partnerships and limited liability companies and will refer to these entities, collectively, as the “company.”

2. RECONCILE THE TWO RELATIONSHIPS.

a. General. When taking on a business partner, in any form, it is important that the existing owners and the employee have a full understanding of each party's expectations. This may be of even greater importance when the person involved is a key employee who is converting to an owner. In the broad picture, the admittance of the employee into the

company should be viewed as a benefit to both, and a strengthening of the relationship between the company and the employee; however, with poor communication, a lack of understanding expectations can have the opposite effect.

b. Review of Employment Agreement. When a company contemplates elevating an employee to the status of “owner” in the company, it is important that the parties first conduct a review of the existing employment agreement or employment documentation that sets out the manner in which the employee has historically engaged with the company. A review of this documentation in the light of the new “ownership” arrangement will allow the parties to highlight changes that will need to be addressed in the employee’s employment or new “partner service” arrangement with the company.

Often the company will keep in place the old employment agreement and simply add the person as a party to the entity documents. This approach can create complications, as in many cases the documents may be in conflict with each other, and in other cases the documents may cause great ambiguity.

After a careful review of the existing employment documentation and reflection on the new “partner service” arrangement, the parties should consider (i) eliminating the employment agreement and replacing it with a “partner service agreement” and (ii) modifying the entity documentations to address the service partner’s duties and responsibilities. In the alternative, the parties might (and most often do) modify the existing employment agreement to reflect the new status of the employee as an owner, eliminating all provisions in each of those agreements which may otherwise conflict as found in the company agreement. In each case the parties will need to conform and coordinate (i) the existing employment documentation, and (ii) entity documentation, to reflect the dual status of the service partner. The parties may also have an “Equity Compensation Plan” which is incorporated into its entity documents for this purpose. For companies that fail to take this step there are often complexities and a greater likelihood for conflict if and when the employee is terminated, or otherwise leaves their engagement as a service partner.

3. PROVISIONS FOR CONSIDERATION.

The following are provisions that are typically found in existing employment agreement or employment documentation. In each paragraph we highlight some of the issues that may arise as the parties consider how to redefine their relationship.

i. *Term.* A typical employment arrangement will have a stated term, or will expressly state that it is an “at will” employment arrangement. An “at will” arrangement allows the employer to terminate the employee at any time subject to other provisions of the agreement which may provide for compensation to be paid based on whether the termination was for cause or not for cause.

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