Compensation Issues

At too many firms around the country, the primary roles of the first-year associate are pretty simple: Generate a significant number of billable hours and learn how to be a good lawyer. For this, associates are paid handsomely and expected to thrive. Unfortunately, these twin goals often are placed in direct conflict, and young lawyers tend to focus on the more tangible goal of billing hours. It would be far more beneficial to law firms to adopt an approach advocating a more balanced commitment to the billable hour dilemma, one that emphasizes both billable and nonbillable contributions.

We suggest setting performance (and compensation) guidelines for various phases of associate development that consider objective and subjective criteria. In the examples that follow, we use a three-tiered approach with progress based on merit, not on years of service.

Target Rates

It is not uncommon for a firm to set an associate billable-hour target of 1,800 hours or higher per year. In the major-city firms, 1,800 is almost a minimum acceptable threshold; 2,000-plus hours is the norm. With respect to first-year associates, it's troubling that firms expect more than 1,800 billable hours from individuals who are, for lack of a better word, unskilled. This is not to advocate a reduction in a lawyer's overall commitment to the firm. Focusing solely on billable hours, however, is not the best approach and results in financial and non-financial losses for many. The clients lose because they bear some of the cost of training the associate, may fall victim to an associate who uses a heavy pen when recording time (in part because of the billable target) and may end up with a subpar work product. The young associates lose because they feel pressure to record hours to stay in their firm's goodgraces, even though they may know they are not qualified to handle the task at hand. Finally, the firm loses when associates get burned out or work inefficiently to hit the billable-hours bogey.

Unfortunately, even after the first year the associate's role does not change that much. From the second-year associates to the more senior level, the billable-hours treadmill never stops. In fact, it gets reset every year as a new quota comes into play Jan. 1. In the repetitive process, an associate will continue to record hours and may pick up some mentoring and training. All too often, though, the associate throws in the towel and moves to another firm, to an existing client or even to another industry altogether.

It is time to rethink associate compensation. Over the past few years, a number of firms have eliminated their lock-step compensation systems and replaced them with structures that are merit-based. By taking a more corporate approach to compensation, these firms are way ahead of those that continue to cling to the lock-step structure.

Yet even those that have moved to a merit-based program still consider the basic associate role to be recording as many billable hours as possible. While we favor the merit-based system and expect it to expand throughout the industry, something needs to be done about the continuing overemphasis on billable hours, particularly at the new associate level. This is where our three-tiered approach comes into play.

Phase One

A lawyer operating in the first performance phase should be expected to generate a reasonably high level of billable hours to meet an "employment" threshold. In Washington, D.C., for example, a reasonable level might be 1,700 billable hours.

Obviously, associates who are paid $160,000 per year and record just 1,700 billable hours at an hourly rate below $250 likely will not generate significant profits for the firm (and may generate a loss). We argue that associates who learn their job, generate 1,700 good billable hours and become an integral part of the firm may be more valuable (in the long run) than those who record 2,000 mediocre hours and are burned out within two years. In addition, by not demanding an unreasonable number of billable hours from young lawyers it is likely that their billing rates and realization rates can be somewhat higher to reflect a greater concentration of quality hours.

All this may seem a bit unrealistic in light of today's market compensation expectations. However, just because the billable expectation is set lower does not mean that the new associate should not be working at a pace commensurate with the firm's normal expectations. Rather, the associate should have the freedom to do a significant number of "development" hours (for example, shadowing) without worrying too much about the billable total. In addition, it just might be appropriate to consider lowering the overall compensation cost for young associates, through differential salaries and bonuses, to allow for a better development model.

During Phase One, the lawyer's skills should improve gradually from the level of virtual novice to a competent lawyer, but not one who is ready to lead assignments. Lawyers in Phase One should not be expected to generate new business, though they should be expected to develop an "internal clientele." Other lawyers in the firm should be able to rely on the Phase One lawyer much the way a billing lawyer's clients rely on that lawyer. The key ingredients are lawyering ability, responsiveness, thoroughness and professionalism.

In Phase One, lawyers should be compensated based on their potential rather than their actual results. Bonuses, when awarded, should be based on the development of the associate's skills rather than just productivity. When determining compensation, firms still should look to objective data but also should consider the associate's development and prospects. The firm also should consider subjective contributions, including the associate's reliability, interest in relevant nonbillable activities and overall quality of work.

Phase Two

Lawyers operating in Phase Two (the middle tier) have more advanced skills and should be expected to generate a higher number of billable hours than those in Phase One. In fact, given that their skills are developed but their client development and management responsibilities are likely limited, lawyers in Phase Two may have the highest productivity expectations of any group of lawyers within the firm.

Because of their high productivity, increased billing rates and reduced write-offs, profitability on Phase Two lawyers should be quite high. As most firms that experienced widespread problems with attrition in the late 1990s will attest, losing young associates right after they have been trained and are on the cusp of profitability is not only demoralizing, but also bad for business. In this new model, by focusing on the lawyer's overall development in Phase One, the firm should be in a better position to limit attrition and hold on to those associates who add so much to the bottom line just a few years out of law school.

Lawyers in Phase Two should have a fully developed internal clientele. They should be recognized as skilled, responsive and important members of whatever practice group they are in. As their skills continue to develop, Phase Two lawyers should assume greater responsibility for client work, including taking on supervision of younger associates and being a secondary client contact.

Consistent with the development of the Phase Two lawyer's internal clientele, firms should look to these lawyers to step up and assume some internal role. This may include participating in some of the firm's operational committees (associates, technology, marketing, etc.).

Lawyers in Phase Two also should start to market actively. In Phase One, the primary external marketing vehicle is through minor speaking engagements and published articles, usually as a member of a team. In

Phase Two, lawyers should continue to speak in public and write. They also should work in tandem with partners on client development. This may come in the form of participating in prospect calls and beauty contests or even in off-the-clock visits to key clients to learn more about the client's future needs. For the firm, this kind of interaction can pay significant dividends as clients recognize that competent associates support the partner with whom they most often deal.

In Phase Two, compensation is based on a mix of objective and subjective contributions. As in Phase One, basic objective results are important and should help determine compensation of Phase Two lawyers. The firm also should base compensation for this tier on professional development (can he or she be an effective second chair?), willingness to assume nonbillable roles, and interest in and success at marketing. Bonuses, if any, should be based on the associate's ability to exceed the firm's expectations in objective and subjective performance.

Phase Three

Lawyers in Phase Three (the top tier) are the highest-level associates and those who will become eligible for income or equity partner status. Like Phase Two lawyers, those in Phase Three should be expected to generate a high level of billable hours. However, as their client development and management responsibilities increase, Phase Three lawyers may experience a shift from a concentration on billable hours to an expanding concentration on use of the firm's leverage. Of course, the Phase Three lawyer who does not have direct client responsibility should be expected to produce a higher level of billable hours than one who has a growing book of business.

Lawyers in Phase Three should generate significant profits for the firm. Their realization should be at or above firm averages, productivity should be high, and their billing rates should reflect their experience and expertise. Lawyers who have done a poor job developing an internal clientele or who are negative presences in the firm never should make it to Phase Three (or even Phase Two).

In Phase Three, lawyers should be critical to the success of their given practice area and should be assuming, on a regular basis, a second-chair role on major projects. Also, given that their marketing efforts should be producing results, Phase Three lawyers may play first-chair roles for those clients that they brought to the firm (assuming appropriate levels of experience and skills) or for existing clients that they have effectively expanded. Phase Three lawyers also should play a leading role in junior associate development and training.

Lawyers in this phase should be effective marketers and cross-sellers of the firm's expertise. They should continue to actively seek out opportunities to showcase their expertise and the firm's strengths. Again, this can come through formal presentations and writing. Phase Three lawyers also should play a public role. While it may be unreasonable to expect them to have a huge network of business partners, they should be assuming a more active role in community relations and the like.

By the time a lawyer reaches Phase Three, compensation should be set based on a blend of objective and subjective performance. As the lawyer progresses through the three phases, compensation evolves from being highly objective based to more subjective. After Phase Three (income or equity partner level), lawyers at many firms are compensated within a subjective compensation scheme that considers objective performance. In essence, they are compensated based on their total contribution to the firm over a multiyear period. The system used for Phase Three lawyers should be quite similar to the system used at the partner level.

Progress Will Vary

Progress from one phase to another will vary. It is quite possible that a superstar associate with less on-the-job experience than another will leapfrog the more senior associate. That is how it would work in corporate America, and that is how it should work in the firm.

The choice of practice area also can have an impact on a lawyer's progress through the phases. For example, practice areas such as the Employee Retirement Income Security Act and tax may require a longer stay in Phase One simply because it can take longer to become fully competent at these disciplines than it does at others. However, ideally managed, the value of the individual's time may be higher in more complex practices than in those more easily mastered, which may allow compensation progress, as well.

Over the past couple of years, a number of leading firms have reassessed their entire associate compensation structure. We applaud these efforts and suspect that these firms are operating within the bounds of the compensation structure described previously. The only difference is that we continue to see firms of all shapes and sizes pushing their youngest associates to bill as many hours as possible. While these efforts may help the firm recoup part of the associates' salaries, we are not convinced that it is in the firm's best interests long term.

Missing an Opportunity

As for firms that are still operating with the lock-step structure, they are missing an opportunity. For them, the issue is whether they can first implement a more merit-based approach and then structure the system in a way that promotes associate development, lowers burnout and builds lawyers who will make significant contributions to the firm beyond just billable hours.

Managing Partner Compensation

Good managing partners can be worth their weight in gold, yet many firms regard them as overhead when determining how they should be paid.

Simply put, if the job of a manager is "to make the trains run on time," the job of a leader is to ask where we should lay the tracks--or, perhaps, to suggest that it's time to close down the railroad and start an airline. Most law firms are reasonably well managed but seriously under led. At a time of dramatic change in the legal market, this deficiency can be fatal. Having an effective leader as managing partner, though certainly not a panacea, can go a long way to helping a firm weather the storm of change going on all around us.

Unfortunately, effective leaders are not in abundant supply in most law firms. Contrary to popular myth in the profession, the managing partner's job--at least today--is not one that can be effectively performed by any partner who decides to devote a portion of his or her time to it. Most firms are lucky to have even two or three partners with the skills, temperament, and creativity necessary to be an effective managing partner. And increasingly, to entice those partners to take on such leadership responsibilities, firms must craft compensation packages that recognize the unique work that managing partners perform. This is particularly true in larger firms (of 150 lawyers or more) where the managing partner's job is usually a full-time position.

For some time now, we have been asking managing partners who participate in programs to provide us with anonymous information about their compensation arrangements. From that information, it appears that most managing partners are compensated within the top 10 percent range of partners in their firms, though normally not at the highest level. In some cases, compensation is tied--usually through bonus arrangements--to the firm's financial performance (e.g., meeting budgeted profitability targets or exceeding such targets by "x" percent). In most instances, however, managing partners are compensated in the same way as other partners in their firms, often with some ambiguity about how the "normal criteria" for compensation should apply to someone who is not actively engaged in law practice.

Most managing partners appear to serve 5 to 7 years in their positions, although some stay in office considerably longer. The earlier practice in some firms of setting mandatory term limits of 2 or 3 years, seems to be falling out of favor, and that certainly is a salutary development.

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It takes most managing partners a couple of years to learn the job and to hit their stride as effective leaders. The notion of turning them out of office at that very moment never made much sense and was, frankly, a reflection of the old discredited idea that "any partner" can serve successfully as managing partner.

A particularly tricky compensation issue arises when a managing partner steps down from his or her position. If the individual has served as a full-time managing partner, it is manifestly unfair to throw him or her immediately back into the normal partner compensation pool, especially if--as is the case in most firms--the criteria for "normal" partner compensation are heavily weighted toward client originations or client billings. As a consequence, most firms grant their former managing partners a protected period of two years or so within which their compensation is guaranteed while they seek to rebuild their practices.

When the Managing Partner Steps Down

These guarantee arrangements generally assume that former managing partners will remain at their firms. In a significant number of cases, however, managing partners decide to leave their firms after stepping down from their leadership positions. Sometimes these decisions reflect simply a change in interest on the part of the individuals concerned, a lack of commitment to returning to the full-time practice of law or a desire to pursue other business or professional interests. In other cases, the decisions are driven by the practical difficulties of a former managing partner blending back into the partnership ranks.

In any event, for former managing partners contemplating new careers, the compensation guarantees offered by many firms provide a useful period for exploring other options. We are aware of one firm that even provides an optional severance package for its managing partner, though such arrangements are rare.

Whatever the arrangements for managing partner compensation--either during the individual's tenure in office or afterwards--in most firms the methods of fixing such compensation and evaluating the performance of the managing partner remain fairly ambiguous and ill-defined. Typically, firms try to fit the square peg of the managing partner's functions into the round hole of normal compensation criteria used for evaluating all partners. Thus, if a firm's compensation criteria include, for example, weighted percentages of credit for matters originated, matters billed, and matters supervised, as well as some credit for service to the firm in various administrative capacities, it may be tempting to say that the managing partner will be evaluated simply on the basis of 100 percent of his or her time being devoted to activities in the latter category. That may entitle the managing partner to a nice compensation package, but it will often be one that is--almost by necessity--lower than the compensation of a partner who scores high in credits for origination, billing, or supervision.

The Managing Partner as Rainmaker

This outcome reflects the commonly held view that firms must generously reward rainmakers while assigning a lower compensation priority to those lawyers who are, in effect, part of the firm's overhead. Since a managing partner, under this theory, spends the bulk of his or her time on "non-revenue generating" activities, it is appropriate that he or she should be compensated at a lower level than the firm's real "producers."

The problem with this view is that it seriously distorts the functions and value of an effective managing partner. In point of fact, a managing partner can be an extraordinarily effective rainmaker, though perhaps in somewhat different ways than firms are used to considering.

A managing partner who steers his or her firm into an important new practice area or who successfully phases out an unprofitable practice contributes to the firm's bottom line just as surely and significantly as a partner who brings in a new piece of business. Likewise, a managing partner who helps position his or her firm prominently in its market and provides the technology systems necessary to service complex client matters deserves as much credit for landing a new client attracted to the firm's name and its technology as the partner who happens to lead the team in the "beauty contest" that actually succeeds in getting the client signed up.

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Also, a managing partner who, in the process of regular visits with key clients, discovers and resolves a significant problem in the relationship between the firm and one of its major clients, surely deserves as much credit for the firm keeping that client as the lawyer who is listed as the billing partner.

All of which is to say that, in thinking about managing partner compensation, firms should view their managing partners as significant potential rainmakers and not just as part of the overhead. This is an idea that is hardly surprising in most business enterprises. We dare say that Jack Welch never made many direct sales of products or services for General Electric companies, but it would be foolish to say that Welch--and the vision and direction he provided to General Electric--was not enormously important to the success of the company or to the confidence and trust that customers were willing to repose in General Electric. Effective managing partners are "rainmakers" in the same way, and they deserve to be fairly compensated for their efforts.

It is encouraging that law firms are beginning to think seriously about how they compensate their managing partners. What remains is to understand that visionary and inspiring leaders are as essential to the future of modern law firms as experienced CEOs are to other types of business enterprises. Managing partners are in unique positions to help guide their firms through the challenging and largely uncharted waters of today's changing legal market. When they succeed, their contributions to the long-term economic health of their firms can be enormously significant. Firms that understand this fact--and that are prepared to compensate their managing partners fairly for the jobs they do--will reap their rewards many times over.

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