Compensation for Partners Is Never an Easy Thing

For many law firms the past decade has brought remarkable growth. Firms added more lawyers to their ranks. And brisk business kept these lawyers busy making money. This trend was a reflection of improved economics. Many firms enjoyed consistent, double-digit growth in per-partner profits. From the outside it seemed the best of times: Why wouldn`t the majority of partners be relatively content with their financial position?
Interestingly, another trend that accompanied this was increased lateral partner recruitment--and it affected existing partner's views of their compensation. Lateral partner hiring begs the question: If times were so good across the board, why did so many attorneys jump ship to other firms?

With improved fiscal performance and the workload it reflects, many firms had to turn away work. At the same time their swollen financial resources allowed these firms to lure key lateral partners. Many laterals based their decision to leave one firm in favor of another, in part, on their dissatisfaction with their present firm's compensation system. For some the main issue was not the actual dollar value of their compensation, but the perception of inappropriate disparities in compensation among partners. In other words, instead of focusing on their steadily increasing individual compensation, partners tend to compare their remuneration to that of their colleagues.

Managing partners and firm administrators rank compensation setting as one of their most difficult job responsibilities. Appropriately compensating a firm's top rainmakers, while also rewarding service partners fairly, presents a significant challenge. The dilemma lies, in part, in the fact that there is no single compensation system suitable for every firm.

The perfect system is firm dependent, with each system having certain strengths and weaknesses. What is right for one firm may be destructive to another. To understand current compensation systems and the direction in which they are headed, it is insightful to review where they have been and what pitfalls they have encountered along the way.

Compensation Systems Evolution

Historically, there was no such thing as a formal partner compensation system in most firms. Divvying the profits was easier when law firms were dramatically smaller - firm owners paid their bills, their staff, put a little aside for reserve and took home the rest. In fact, not long ago the largest law firm in the world had fewer than 100 lawyers.

In these not-so-old days, the criteria for partnership were based primarily on "up or out" thinking. In these firms associates were either promoted to partner status or excused from the firm. Most associates made partner: The criteria focused solely on professional rather than economic standards. In fact, economics were the last thing considered when admitting an associate to the partnership. Accordingly, the rationale in setting partner compensation was rather straightforward and flowed from the notion of "once a partner, always a partner."

These firms did distribute the post expense income equally among the partners. If no funds were left, the partners were not paid. These equal-pay systems relied on the essential assumption that every partner's contribution was of equal value. While their simplicity made equal-pay systems easy to administer, they had at least one major drawback: They completely ignored individual effort. On the positive side, equal-pay systems fostered team building (long before it became a catch phrase) because the focus was on increasing the size of the pie, rather than individual shares.

As firms and the number of partners within them grew, it became evident that profits and losses could no longer be shared equally. Under the equal-pay system, associates admitted to the partnership following years of hard work were eligible for an equal share of firm profits. Naturally, existing partners argued that the newest partners should not be entitled to share as at the same level as the others, most of whom were founding partners.

The rationale for setting compensation, therefore, became seniority. If you made partner, the presumption was that the longer you practiced law, the more valuable you were to clients and the firm. It followed, therefore, that you should earn more than should those with fewer years of experience. The lock-step, seniority-driven compensation system was born.

In lock-step systems, compensation increases are based on age at the firm and not merit. Partners with the same number of years of experience are compensated alike, regardless of the work they perform, and seniority is valued more than actual contribution. Of course, lock-step systems have their own problems and are subject to abuse. In addition to failing to provide any incentive to enhance individual performance, lock-step structures foster an environment in which partners simply have to show up in order to earn more and in some ways, are encouraged to essentially retire long before they actually leave the firm.

On the positive side, if all partners agree to use a lock-step system (which is easier in theory than in practice), the system itself could eliminate all disagreements over pay discrepancies. Some U.S. firms continue to use lock-step or modified lock-step systems. Similar to those that use equal-pay systems, these firms are usually small, highly profitable and comprised of partners with a consistent work ethic. In addition, partners in lock-step firms are often of the same general age and have reached agreement regarding their compensation structure, regardless of its inherent defects.

Lock-step systems' heyday lasted about 10 years. Partners liked these systems because they were very simple and easy to understand. Unfortunately, as the number of partners within such systems grew, there was always the individual who stopped carrying "his" load--it was usually "his" because at the time there were very few female partners. As these systems were based upon the presumption that each partner devoted his full and best efforts to the practice and to the firm, accountability was implied rather than required.

In an atmosphere where partnership was defined by professional standards rather than economic ones, partners were loath to confront colleagues who ceased to carry their loads. To avoid confrontation, there was a shift to arithmetic, formula-driven compensation systems that were viewed as dispassionate, objective and, therefore, ultimately fair. Formula systems were based on the assumption that a mathematical formula (for example, 30 percent of originating attorney collections plus 60 percent of working attorney collections, etc.) could appropriately value a partner's contribution.

There is a working simplicity to a formula-allocation mechanism. However, as with the equal-pay and lock-step systems, objective systems are not firm focused and fail to compensate partners for their efforts to build the firm through cross-selling, training and proper management. In addition, partners rarely establish a formula and accept the outcome. They often tinker with the system or manipulate the formula's input in an attempt to skew the results in their favor.

Objective systems work best in firms that are profit-center oriented, comprised of partners that want to work together even if they may not fully trust each other, or in firms that have diverse practices with no need to cross-sell. Strict, eat-what-you-kill formula systems still exist today; however, they are typically found in first-generation firms or firms loaded with laterals who believed that they were inappropriately compensated by their prior firm's use of a lock-step, equal-pay, or more subjective compensation structure.

Objective systems came into favor rather rapidly. Just as quickly, however, their shortcomings far outweighed their perceived advantage of fairness. Also, the systems damaged firm management. As Charles J. Santangelo wrote in "Partnership Compensation Systems--Why Objective Formulas Don't Work" in Legal Economics (1984), ".[F]ormula systems tend to destroy firm leadership. Instead of firm managers dealing with 'unproductive' attorneys in a direct, subjective manner, they believe the system 'will take care of the problem.' Sadly, the 'system' rarely takes care of the problem, and the unproductive partner is usually permitted to continue in the firm."

With their unwillingness to deal with unproductive partners, firm leaders often found themselves in the unenviable position of managing based on the formula, and nothing else.

Where Are We Now?

There are very few lock-step, seniority-driven systems left in the United States. Those firms in which they do exist have three interesting characteristics:
In these firms it is extremely difficult to become an equity partner.
In these firms partner remuneration is usually in the seven figures.
In these firms the partners are held accountable, by the management of the firm, to the very high standards.
Likewise, there are very few arithmetic-formula compensation systems remaining. Those that have endured have been manipulated to the point of which many partners can no longer explain their workings.

This evolution has yielded the common partnership compensation systems that drive law firms today: subjective, rough-justice compensation systems that hold partners accountable to a set of articulated criteria applied by firm management, which include both objective and subjective standards. The focus of these systems is on the individual partner's total contribution, with the assessment being made by a few partners who rely on feedback from others.

The actual working mechanism, however, is a bit more complex. Firms that use subjective systems often rely on input from department heads and other partners, measure partner performance against personal performance plans and conduct individual partner interviews to set compensation. It is common for these firms to use bonus pools to reward extraordinary performance in a given year.

While the steps are many, complaints about the process are generally limited. The new systems, if properly implemented, allow partners some input into how the firm will distribute profits. As with the objective compensation systems, subjective systems also have their drawbacks. However, instead of accepting unproductive behavior, the primary problem with subjective systems is inappropriate application. Many firms purport to have subjective systems, but focus on objective data or fail to define the subjective criteria. Subjective systems work best when partners understand and accept the criteria, the partners ultimately setting compensation seek input from all sources, and the criteria are applied uniformly.

Still other firms use hybrid systems. For example, a firm may set compensation based on a formula for 70 percent of compensation and lock-step for the remainder, or some other combination. The success of the hybrid system varies by firm. Unfortunately, more often than not, these combination systems suffer the negative aspects of the stand-alone systems from which they originated, necessitating that a firm overcome the negative aspects of both systems.

So, Which System is Best?

No system is perfect in every instance - though each can be in specific situations. In reality, a lock-step system has the potential to work well in one firm, but might fail in a similar firm in the same market. In the end, the key to the process is profitability. No system can make up for lack of profits. It follows then, that the best system is one that encourages partners to operate profitably.

Due in part to the latest advances in technology, many firms are exploring practice-area profitability when setting compensation. This makes sense: Without knowing if a particular practice area is profitable, a firm cannot determine if it should focus on that practice or turn its attention to another area.

A firm must first decide what it is trying to achieve within the practice. Does it want to:
make money?
manage risk?
make an investment?
The answers to these questions, in combination with the way the profitability analysis is used, can have a significant impact on partner behavior. For example, if a firm wants to invest in a new practice and relies on practice-area profitability to allocate profits, who would want to head that practice? Probably no one. Unless the practice is a sure thing and there are clients knocking on the door--which in reality does not exist --it may operate at a loss or only break even for a period of time. Partners may not be willing to lead a start-up practice if they are concerned about the effect of such a move on their compensation. Ultimately, firms should evaluate their practices - both objectively and subjectively - in terms of the expectations for the practice and the partner.

When partner compensation is based on practice-group profitability, group performance is paramount. Because they are being judged as a group, partners in each area will focus on increasing the bottom-line profitability of their department, rather than improving their own performance statistics. When firms analyze practice-group profitability, there is a real opportunity to reward initiatives that are not revealed in statistical reports--leadership, delegation, mentoring, etc. Practice-area profitability has its own pitfalls--one being the allocation of indirect overhead. Virtually any partner can argue that their indirect overhead allocation is incorrect, and those that do probably have a good point. After all, is there any way to allocate the cost of office refreshments or other overhead items accurately? Probably not. To avoid this dispute altogether, it may make sense to completely exclude indirect overhead allocations from the process. Instead, the practice area calculation would focus on each area's contribution to indirect overhead and firm profits.

Arguably, some firms are taking profitability analysis too far. While there is merit in looking at practice-area profitability, attempts to calculate the profitability of individual partners are disconcerting. When partners understand that their personal profitability is being analyzed, they are likely to look out for themselves and focus on their own numbers and clients. This is contrary to the team environment that most firms are trying to foster.

In the end, it may be best to use data to support subjective compensation allocations, rather than directly link these numbers to compensation.

Regardless of Type, What Does a Good System Do?
Rewards a partner's total contribution
A partner's total contribution includes all of the normal productivity measures in addition to each partner's impact on teamwork, practice management, marketing, effective use of leverage and the like. A compensation system that considers total contribution usually meets another key criteria - it ensures that the client's interests are well served.
Promotes Trust
Because a firm's compensation criteria are defined and applied predictably year after year good systems ease partner's fears. These systems also reduce the likelihood of major swings in compensation from year to year and minimize small, potentially diverse differences in compensation. Ultimately, a good compensation system creates a sense of fairness. In any given year, certain partners will feel underpaid and underappreciated, but that is okay. No system will be totally fair every year, a good system should be

equitable over the longer term.

Flexibility

A sound compensation system can adjust to changing times, evolving firm needs and firm expansion. The ability to modify the system to meet firm needs and keep us with industry changes can ensure future stability.

Promotes profitability

Many firms set up their compensation systems to penalize partners who accept, or fail to properly delegate, low-rate work when better work is available at higher rates.

What Do Successful Firms Do?

In the work world, regardless of industry, good managers recognize that "you get what you reward." Typically, it is management that sets the rewards, which are a direct reflection of the firm's values. A compensation is a management tool--a very important one: For example, if management wants to encourage team building and delegation, the compensation system should reward both.

Here's a checklist to assess if your compensation system works:

Compensation criteria are clearly defined.

All partners are keenly aware of the criteria and the weight that each carries.

The system accounts for both long- and short-term contribution. Many firms rely on a three- to five-year lookback period to help even out the peaks and valleys of an individual partner's performance. The multiyear lookback can also allow for a more gradual decrease in compensation for senior partners as they head toward retirement, rather than a dramatic decrease as their practice declines.

Compensation is set by a committee made of a representative sample of respected, trusted partners from most, if not all, departments. While the committee does not have to be separate from a firm's management committee, it is critical that the compensation committee includes members of the management committee.

Capital planning is tied to compensation. While many firms still rely on flat capital contributions from all partners, an increasing number base the contribution on relative compensation (point) allocations. They reason that allocations based upon compensation level are more equitable to younger partners. For example, a $50,000 contribution to someone making in the high six figures may be easier to handle than it would be for a younger partner starting out in the low six figures.

What Role Does Management Play?

The ultimate authority of a management committee or a managing partner rests in the ability to set the compensation of partners. Without such authority, any management/executive committee or managing partner is essentially powerless to hold partners accountable and manage the firm effectively. Partners who accept firmwide management responsibility without the authority to set compensation are setting themselves up for failure.

Final management/compensation committee allocations should not be open to appeal from the firm as a whole. This supports the idea that unless decisions are final and binding, the management/compensation committee is powerless.

Lastly, in most firms, one or more equity partners give up a portion, if not all, of their practice to run the firm. In firms where the managing partner serves multiple terms and is poised to re-enter active practice with virtually no book of business, determining his/her fit within the compensation structure can be daunting. Most firms recognize this and offer former managing partners a start-up phase during which to revitalize their practices, while guaranteeing their compensation throughout this period.

Where Do We Go From Here?

As firms continue to grow in size, profitability and number of branches, the criteria used to set compensation will expand. The next steps in this process will likely include formalizing a method to solicit client opinions and ironing out the kinks in profitability analysis.

Some firms will likely discontinue the practice of tracking billing and originating attorney statistics, arguing correctly that they know who produces what and that reporting specific numbers can lead to divisiveness. Others will reassess the value derived from cross marketing and develop improved methods with which to quantify it. Firms will do a better job of rewarding marketing efforts and team building by learning to capture and use quantifiable data.