

The Top Two Different Ways Law Firm Partners Are Compensated

By A. Harrison Barnes

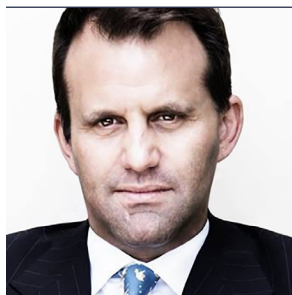
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The Top Two Different Ways Law Firm Partners Are Compensated

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Summary

Learn more about the history of law firm partner compensation and how partners are compensated in law firms today in this article.

There has been considerable change in law firm partner compensation systems over the past 15 years and two basic systems exist today – subjective systems and lockstep systems – according to a recent white paper. U.S. law firms overwhelmingly use subjective systems in which committees allocate compensation based on a number of factors, the most important of which is client origination.

The topic of partner compensation is difficult and controversial. The reason is because while in theory law firms are groups of equals at the partner level, when certain partners are paid more than others questions inevitably arise as to why those partners are valued more highly and whether they actually make greater contributions to their firms. Law firm compensation system architects must continually ask: How can we most accurately and fairly quantify “contribution” to the firm?

In this article we explain the various partner compensation systems in use by law firms during the past 15 years. We also discuss

ways in which some partners would like to see their compensation systems change as well as a possible new trend towards integrating a profitability metric into compensation systems.

A Look at the Numbers

Before we discuss compensation systems, it is worth reviewing some context. What are law firm partners making these days, whichever system is being used? The 2014 numbers are in and the answer varies depending on factors such as partnership status, practice area, location, and gender.

Top equity partners at top firms earned millions of dollars in 2014, according to The American Lawyer, with an overall average profit per partner of \$1,550,000. The firm with the highest average PPP was **Wachtell, Lipton** at \$5,500,000. Next in line was **Quinn Emanuel** at \$4,925,000, then Paul, Weiss at \$3,845,000, **Sullivan & Cromwell** at \$3,680,000, and Cahill Gordon at \$3,615,000 in fifth place.

Somewhat different and additional information was revealed by another 2014 partner compensation survey. That survey, which had a response rate of 4.9%, revealed an average compensation for equity partners in U.S. law firms of \$971,000 as compared with \$338,000 for non-equity partners, indicating a considerable gulf between equity partners and non-equity partners.

The survey also found that partners in the largest firms (1,000 or more attorneys) earned the most money, with average compensation of \$978,000. Corporate partners reported the highest average compensation out of seven practice areas (\$893,000) and labor & employment partners reported the lowest (\$503,000).

Silicon Valley and New York partners did much better than those in Minneapolis and Seattle (\$1,167,000 and \$1,106,000 compared with \$463,000 and \$438,000). Male partners earned on average more than female partners (\$779,000 versus \$531,000). Additionally, firms with “open” compensation systems had higher averages than firms with “partially open” or “closed” systems (\$843,000, \$574,000, and \$484,000, respectively).

Two-Tiered Partnerships – Equity Partners Versus Non-Equity Partners

One of the main trends in law firm compensation systems is the trend towards adopting two-tiered partnership systems

with equity partners and non-equity partners. In these systems, equity partners have ownership stakes in their firms just like shareholders of corporations, and thus the opportunity to share in the firms’ profits and losses. Non-equity partners typically get paid salaries that are higher than associate salaries but not as high as the potential partnership profits enjoyed by equity partners.

According to [Edge International’s 2015 Global Partner Compensation System Survey](#), more law firms worldwide are using the two-tiered partnership system and the trend is expected

“According to Edge International’s 2015 Global Partner Compensation System Survey, more law firms worldwide are using the two-tiered partnership system and the trend is expected to continue.”

to continue. Ninety-six percent of U.S. firms have more than one partnership tier in which non-equity partners are generally paid fixed compensation plus bonus.

Transparency Issues – Open Systems Versus Closed Systems

Another difference among law firm compensation systems is in their relative levels of transparency. Partners can learn what every other partner is making in “open” systems but not in “closed” systems. Yet sometimes even open systems are not exactly transparent, as they can contain “need to know” clauses or provisions that allow access to information only under certain conditions such as being viewed in the managing partner’s office.

The vast majority (92%) of U.S. firms use open compensation systems, according to the Edge

Survey. Moreover, the market appears to favor transparency. We can see from the other 2014 survey that firms with open systems reported higher average partner compensation than firms with partially open or closed systems. Additionally, when partners were queried as to what changes they would like to see in their firms' systems, 8% advocated a move towards open compensation systems.

Systems Change Over Time in Accordance with Market Forces and Values

When it comes to partner compensation systems, the main issue – and the thorny one – generally involves the valuation of the relative stakes of equity partners. Law firms are continually challenged to make better assessments in this area and the result is constant evolution and change.

“All professional service firms must realize that a compensation system is a living and breathing beast,” Michael J. Anderson wrote in his 2001 article **Partner Compensation Systems Used in Professional Service Firms**, “It will need to change or adjust to meet the demands of changing times—either to satisfy partner concerns or to complement and reward compliance with ever-changing firm goals...Try as you might, some people will always think you are singling them out for a smaller piece of the pie. The best you can hope for is that most will view the system as relatively fair.”

As an indication of how quickly things can change, there were seven main types of compensation systems being used in 2001,

whereas today there are only two main systems in play worldwide and only one system predominating in U.S. law firms. The seven systems in effect in 2001 were:

- *Equal Partnership* – Partners share equally with similarly situated partners (i.e. all senior partners are treated equally and all junior partners are treated equally).
- *Lockstep* – Partners get increasing shares of profits based on seniority.
- *Modified Hale and Dorr* – Partners are allocated different percentages of profits based on whether they are “Finders” (originate clients), “Mindors” (maintain the clients) or “Grinders” (do the work for the clients).
- *Simple Unit* – Partners are assigned unit/points for each year with the firm, for fees billed or fees received, and for client generation.
- *50/50 Subjective-Objective* – Partners are compensated according to objective criteria (billings and originations) as well as subjective criteria.
- *Team Building* – Partners are compensated according to percentages based on how well the firm does, how well their practice areas do, and how well the individual partner does.
- *Eat What You Kill* – Partners are rewarded almost exclusively according to personal performance without regard to how well the firm does as a whole.

Generally speaking, these compensation systems allocate financial rewards in accordance with a firm's values. Equal

partnership and team building systems thus emphasize cooperation and the profit of the whole, while lockstep systems emphasize seniority. Eat what you kill systems emphasize individual performance above group performance.

“Subjective” Systems Based on Origination Predominate in U.S. Firms Today

Today, there are two main compensation systems being used by law firms around the globe, according to Aderant’s 2015 white paper **Your Partner Compensation System Can Be Better: Here’s How**. They are as follows:

- *Subjective, Modified Subjective or Combination* – Partners are compensated based on “subjective” decisions of a committee, or based on statistical performance with the possibility of subjective modification.
- *Lockstep* – Partners are compensated according to fixed levels of percentages of a firm’s profits based on increasingly progressing steps often based on seniority.

Interestingly, firms today tend to use one system versus the other depending on where they are located in the world. Subjective compensation systems predominate in North America. As of 2015, nearly all of U.S. and Canadian firms had either a subjective system or a combination formula, with only about five percent using a lockstep system. Meanwhile, 90% of European

firms, 80% of U.K. firms and 50% of Australian and New Zealand firms had lockstep systems.

Client origination (bringing in business) is the most important factor used to allocate compensation by U.S. law firms, according to the 2015 Edge Survey. The next most important factor is personal performance (billable hours), followed by technical expertise and then firm work. Origination is so vital to partner compensation in the U.S. that 60% of partners responding valued it as “extremely important.”

Partner Dissatisfaction with Existing Systems

Even though the 2014 partner compensation figures reveal that law firm partners of all stripes are doing very well financially, the survey indicates that a majority of partners are unhappy with current compensation systems. Fifty-five percent of partners thought they should be “earning more” as compared with 45% who thought their compensation was “about right.”

Over half of the partners gave commentary about what they would like to see changed in their compensation systems. The comments revealed that partners (at least those

who cared enough to respond) would like to see a more holistic approach to compensation decisions. Most partners agreed that

“Client origination (bringing in business) is the most important factor used to allocate compensation by U.S. law firms.”

client origination is an important piece of the puzzle, but 19.2% felt that qualitative factors such as firm management, good citizenship,

mentoring, commitment to diversity and pro bono activities should be valued along with the financial metrics. Even partners who advocated quantitative formulas felt that the idea of originations should be recast to include more partners and statistical measures such as profitability and billable hours should receive greater emphasis.

Other partners suggested revising compensation systems to allocate more value to cross-selling and collaboration efforts, specialized practices and non-equity partners, and to involve greater transparency.

In light of the suggestions, the authors' of the study concluded: "There is a deeply emotional component to the compensation process because it is typically the only means by which a firm evaluates an individual partner's performance. Partners want to be valued by their firms; therefore, they want their firms' compensation systems to value most heavily the measures and factors that put them and their practices in the best evaluative light."

Trend Towards a Profitability Metric

Partners are not the only ones who are seeing room for improvement in their firms' compensation systems. Managers also are taking a critical look at existing systems to determine if they are as effective as they could be at rewarding behavior that will best serve their firms over time. As a result, some firms are looking to incorporate profitability metrics into their systems as a way to better incentivize efficiency and long-term growth. The idea is that while some partners bring in significant short-term revenue through origination, they may do so in an inefficient manner. Meanwhile,

other partners may originate relatively less business but do so using far fewer resources. So at the end of the day, which partner is contributing more to the firm?

Technology now exists to measure profitability according to any number of factors including client, matter, practice area, office and partner. Advocates hope this technology can help better quantify partners' actual contributions to a firm in a way that enhances transparency and accountability and alleviates partner dissatisfaction.

According to the white paper: "By adopting the available data tools that now allow firms to evaluate performance using clear metrics, partners could avoid much of the lingering suspicion of the compensation process. Not to mention the need to deemphasize the current laser-focus on originations as the primary component of compensation decisions. No system is perfect, but business intelligence offers a much stronger basis for a robust compensation system that rewards profitability."

Conclusions

Partner compensation systems continue to change along with market conditions and firm values. Partners are bringing home large paychecks, but many would like to see their firms' compensation systems evolve to accord more value to activities and individuals beyond origination and originating partners. Managers also are looking to incorporate profitability metrics into compensation systems. In the coming years, we may see changes that make partner compensation systems more holistic yet more statistical at the same time.

Additional Article Resource

Please see the following article for more information:

What Law Firm Titles Mean: Of Counsel, Non-Equity Partner, Equity Partner Explained