Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

FEATURED ARTICLES

Law Firm Compensation Systems

Partner Compensation Systems in Professional Services Firms
Michael J. Anderson

Marketing, Origination and Formulaic Law Firm Compensation Systems
Alan R. Olson

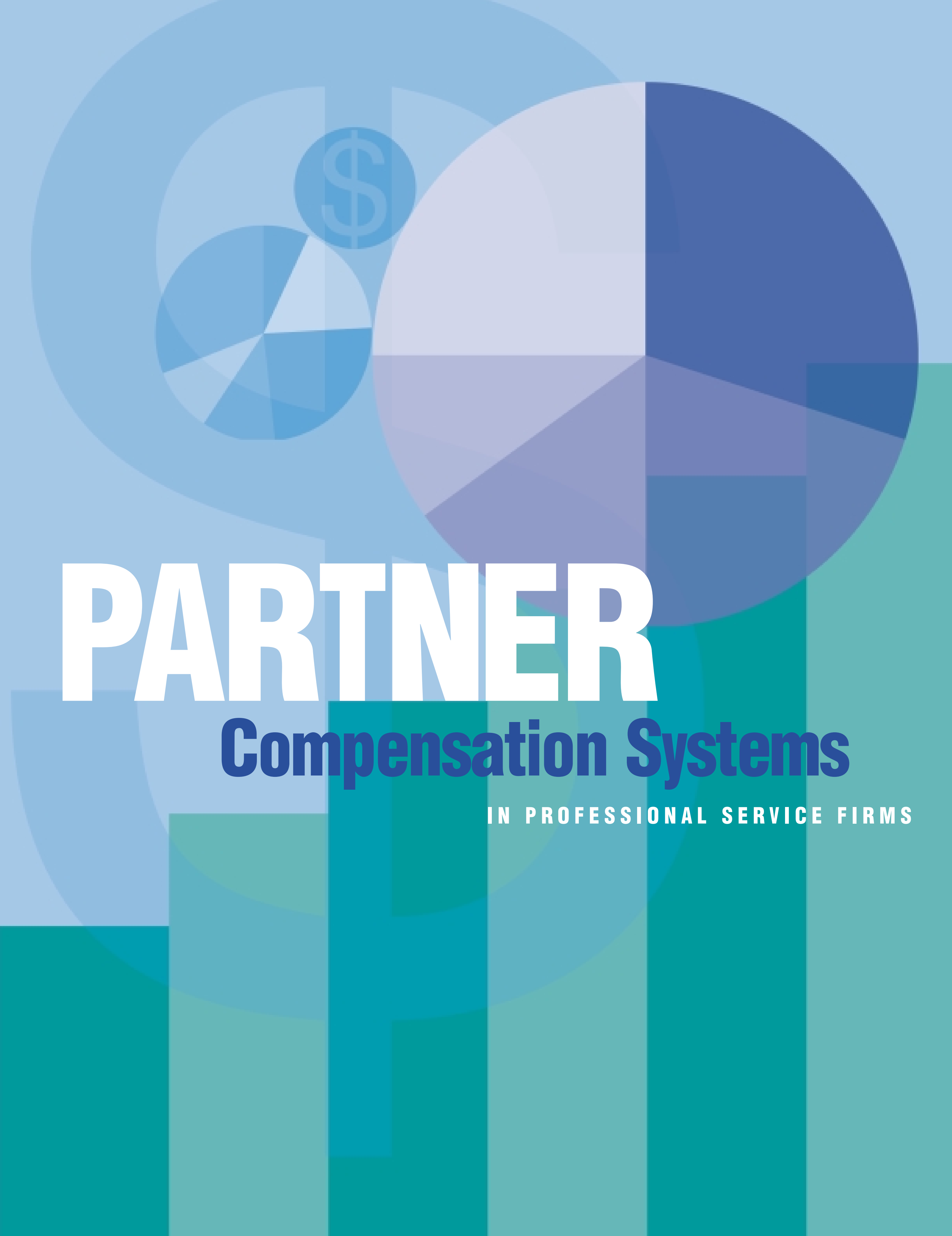
Trends in Partner Compensation Systems in Law Firms
Colin Cameron

Dealing with Tensions Surrounding Partner Compensation
Joel A. Rose

Rethinking Partner Compensation Criteria
Howard L. Mudrick

February 2013

TheRemsenGroup
727 Kirkwood Avenue - Atlanta, GA - 30316
404.885.9100 - www.TheRemsenGroup.com



PARTNER Compensation Systems

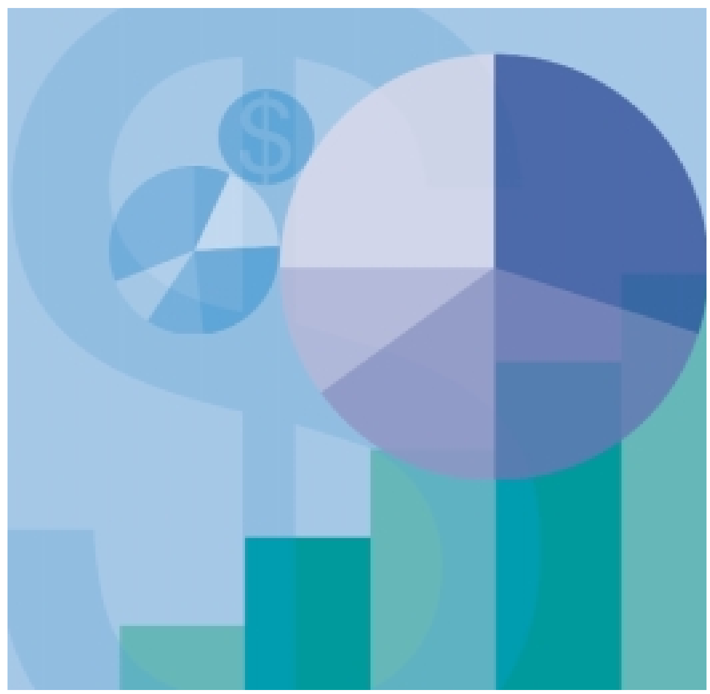
IN PROFESSIONAL SERVICE FIRMS

Partner Compensation

SYSTEMS USED IN PROFESSIONAL SERVICES FIRMS

BY MICHAEL J. ANDERSON • EDGE INTERNATIONAL

Before you overhaul of your firm's compensation system, consider this analysis of the strengths and weaknesses of the most common systems used in professional service firms. And keep in mind the basic truths about compensation.



In our work, we are exposed to a variety of methods used by professional services firms, particularly lawyers and accountants, to divide partnership profit. Compensation systems used We have found that almost all compensation systems fall into seven basic categories—or variations of these categories:

1. **Equal Partnership**
2. **Lock-Step**
3. **Modified Hale and Dorr**
4. **Simple Unit**
5. **50/50 Subjective-Objective**
6. **Team Building**
7. **Eat What You Kill**

BASIC TRUTHS ABOUT COMPENSATION SYSTEMS

If your firm is considering anything from a minor adjustment to a major overhaul of your compensation system there are some basic truths that you should keep in mind.

- **There is no magic system that will satisfy all partners, meet all strategic goals and never need to be changed.** All professional service firms must realize that a compensation system is a living and breathing beast. 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. (And we all know that the only constant in professional life today is change.) 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.

■ **A compensation system should be related to your firm's strategic goals.** For example, if you think that the mentoring of juniors is a worthwhile pursuit, then you had better have some form of reward for it in your compensation system or the message to your partners is that it is valueless and will only be done through their altruism and sense of teamwork.

Every type of compensation system has compelling reasons for adoption, or strengths, and often just as compelling reasons why it should *not* be adopted, or weaknesses. While a system might deal handily with partner concern A, it might have a reverse effect on partner concern B. For example, a system that rewards rainmakers might solve the concern of those partners most responsible for bringing in the work. If, however, the system does not reward the partners who take responsibility for those clients, you will offend a vital group of partners. You can bring in all the work in the world, but you will not improve your profitability if no one takes responsibility for the clients. The reverse is also true: The partners who are capable client managers will have nothing to do unless the rainmakers bring in the clients.

■ **A fair system can only be created when all those affected openly discuss the strengths and weaknesses of any proposed scheme.** This type of brainstorming session is the only way to get the issues out and dealt with in appropriately. In very large firms, each interest group in the partnership might send a representative to such a session, as opposed to asking every partner to attend and participate.

Of course, some firm leaders may think they can solve all of their compensation system problems and arguments by hiring a consultant who will meet with every partner and then create a report that will be acceptable to all. We relate this type of consulting to one of our favorite little stories:

> *They saw the consultant like a seagull flying in from afar. It circled their heads and dropped something white in their hands. They thought it was a report. Only after the seagull had disappeared from sight did they discover what it really was.*

■ **K.I.S.S. (Keep It Simple Stupid).** A compensation system that leaves most partners scratching their heads over the calculation of their individual compensation is doomed to fail. *You* may think it is straightforward, but be sure others agree with you.

"The impact of the most profitable partners leaving an equality firm can be devastating. Eventually only the poorer performing partners remain, profitability declines and the partnership dissolves."

THE SEVEN BASIC COMPENSATION PLANS

The following are the seven basic compensation plans in use by professional firms around the world, along with analysis of their strengths and weaknesses. Most firms employ a variation of one or another of these.

THE EQUAL PARTNERSHIP

This system is typically used only by smaller firms. Basically, all partners share in profits equally or equally within defined *groups* of partners. Here is a simple example. In a firm with eight partners that are divided into four senior partners and four junior partners, the senior partners equally share 60 percent of the firm's total profits (15 percent each), while junior partners equally share 40 percent of the firm's total profits (10 percent each). In a more complicated version, various levels of partners may share equally, but partners may move from one group to another each year—up or down, depending on their performance.

There is an underlying assumption that all partners are contributing to the overall firm performance equally, albeit in different ways. Some do it through their billable performance while others do it through non-billable contributions. It is usually when this assumption of equal contributions no longer appears to be true that the partnership starts to look for a fairer compensation system.

Strengths

In an equal partnership, the bigger the pie, the bigger a partner's share of profits. Therefore the paramount financial concern is firm profitability. Individual performance is much less important than how well the firm does as a whole. As long as the firm does well, then the individual partners will do well. This allows for individuals to have performance swings—up years and down years—as long as overall the firm does well. Usually, performance is measured over a longer term basis, say three to five years, as opposed to limiting compensation criteria to a single year's performance.

Because individual performance is less important that overall firm performance, equal partnerships tend to be a great deal more collegial than partnerships that place more emphasis on individual numbers. This, in turn, allows partners to focus their competitive instincts externally rather than internally. The question shifts from "how *I* outperform my partners" to "how *we* outperform other firms".

Some firms choose the equality system because they find the whole pie splitting exercise—complete with finger pointing—to be repulsive. There is much to be said for avoiding the conflicts and internal bickering that develop in many firms at compensation time.

Another strength is that partners have a certain sense of security as to what their income will be in any given year or at any given time during that year. This, of course, reduces the amount of schizophrenia most partners feel when thinking about compensation. They don't fret over questions like "Are my numbers good enough?" or "Did Joe do better than me?" or "Will my non-billable efforts really be recognized?"

In such as system most partners work well together. They do not hoard either clients or files because their goal is to increase the total profit pie, not their own numbers.

This sounds pretty good, doesn't it? Unfortunately, there is a downside too.

Weaknesses

Equal partnerships face some very serious problems, mostly having to do with incentives or, more properly put, a *lack* of incentives. There is no financial reason or reward for the individual partner to push beyond normal partner performance levels. There is seldom much of an individual financial difference between the partner who works 12-hour days and the partner who plays golf most afternoons. There is no perceived or real value in working harder.

This lack of incentives can lead to resentment of those partners who are viewed as lazy or underachieving. If not promptly dealt with, this resentment can lead to a serious erosion of the collegiality that an equal partnership strives so hard to develop.

What's more, those partners who are more profitable, who put in more hours, bring in more clients or make valuable non-billable efforts will soon do more than merely resent those partners whom they perceive as doing less. They will leave to join firms where they feel their efforts are more appreciated and better rewarded in the financial sense. The impact of the most profitable partners leaving an equality firm can be devastating. Eventually only the poorer performing partners remain, profitability declines and the partnership dissolves because is no point in the staying together as a firm. The death knell is sounded because the firm is then only as good as its lowest common denominator or weakest link.

To avoid resentment among partners and maximize profitability, leaders of most modern firms will tell you that there must be at least some sense that individual efforts will be recognized and rewarded.

THE LOCK-STEP SYSTEM

The lock-step system is used by a fair number of firms that are organized in a traditional fashion. The basic concept is that each partner is rewarded an ever-increasing share of the firm's profits, based solely on seniority. The longer a partner remains with a firm, the more money the partner will make.

In a lock-step system, income can be divided exactly along seniority lines or, as with the equality compensation system, divided into levels. For example, the divisions might be senior partners (more than 15 years as a partner), middle partners (5 to 15 years as a partner) and junior partners (1 to 5 years as a partner).

Strengths

The greatest financial rewards in a lock-step compensation system go to those partners who have stayed with the firm for the longest time as a reward for their years of service to the firm. This obviously gives the firm, and probably the management of the firm, a great deal of stability. Few partners, once committed to a Lock Step system, would leave before they had risen to the top of the compensation totem pole.

Partners also have a sense of security from knowing that their share of the profit pie is pre set. The only variable then becomes how big the pie will be. This security can help to create a more collegial atmosphere among the partners.

Like the equality system, lock-step encourages external competition rather than internal competition among partners because the only way to increase individual incomes is by making the overall pie bigger. With no divisive compensation meetings and no internal compensation competition to deal with, many of the partners will expend their energies trying to make the total profit pie bigger so that everyone makes more money. There is no financial advantage to file or client hoarding among the partners so they tend to work well together, again contributing to the collegial atmosphere.

Weaknesses

Like the equality system, lock-step does not directly reward individual contributions and initiatives. As a result, some partners will not expend extra effort when they know that all they need do is contribute at a normal rate to keep progressing along the compensation path.

This lack of financial incentives can have a great impact on a firm's profitability because, in some cases, it is actually a de-motivator. Why bother? In some firms the motto is, "You get what you pay for." Obviously, a lock-step firm cannot accept that kind of thinking if it is to succeed.

In many firms with a lock-step system, the younger partners feel a great deal of resentment by toward the senior partners. Often the attitude of these younger partners is, "What have you done for us lately?" Too often they see senior partners who have slowed down but still command the largest share of firm profits. As one partner said, "He has retired but has just failed to tell the rest of us." That kind of resentment cannot be good for any firm. Eventually it will harm profits and collegiality.

In lock-step firms where senior partners are perceived to be taking more than their appropriate share of profits, there will eventually be an exodus of the younger, hard working partners. They will move to firms that are prepared to recognize and reward their efforts. The result for the firm is lower profits at best, and disintegration at worst disintegration.

Some firms have tried to address this problem by increasing the percentage share of profits each year, but only to a certain level. After a certain point, the percentage starts to drop. For example, each partner may progress until reaching the age of 55 or 60, when their income slowly starts to drop as they prepare for their retirement at 65 or later. The thinking is that most partners reach the peak in terms of willingness to put in the hours and ability to generate profits somewhere between the ages of 45 and 55.

"The system places much more value on individual contributions and much less value on what the firm does overall. The clear assumption is that if everyone is motivated by the compensation system, the firm as a whole will do just fine."

Other firms have tried to address this same problem by setting a maximum number of "points" a partner can accumulate so that the most senior partners don't continue to amass ever-increasing shares of the firm's profits simply by growing older. Rather, they level off at a certain point so that many more of the partners become equal, at least in terms of compensation, at an earlier age.

David Maister, has expounded on the concept that "intolerant lock-step" is a viable way of distributing profits. He says that for a lock-step system to work, it must be *intolerant* of partners who do not meet enunciated expectations. If partners are allowed to under-perform, the system cannot succeed. He cites Skadden Arps as an example of a law firm that uses this method successfully.

MODIFIED HALE AND DORR SYSTEM

Back in the 1940s, the Boston law firm Hale and Dorr created what is regarded as the first incentive-based compensation system. The firm created three categories in which a partner could earn income: "Finder" (originator of the client), "Minder" (responsible for the client) and "Grinder" (the partner actually doing the work). Over the years, this system has been adopted by many professional service firms. The system has evolved, of course, but the basic premise remains the same.

An example of the Modified Hale and Dorr system might be:

- 10 percent of profits to the finders

- 20 percent of profits to the minders
- 60 percent of profits to the grinders
- 10 percent of profits to a discretionary pool, which is allocated at year's end to the partners who have shown exceptional performance.

These percentages can be adjusted each year to address issues that the firm determines are the most important for the coming year. As an illustration, a firm may choose to lower the finder category's percentage if it has plenty of good work coming in, and increase either or both of the minder and grinder categories so that people will focus on getting the work *done*. The following year the focus may shift and percentages can be adjusted to reflect those changes. This makes the system adaptable and flexible.

Strengths

This modified Hale and Dorr system is much better at rewarding the contributions of the individual partners than the equality or lock-step systems. The system places much more value on individual contributions and much less value on what the firm does overall. The clear assumption is that if everyone is motivated by the compensation system, the firm as a whole will do just fine.

Partners knows exactly what they have to do if they wish to increase their income. Many partners prefer such a system because it allows them to become the masters of their own financial destiny, either higher or lower depending on personal goals. For example, this system allows the partner who wants to spend more time with his children while they are growing up to slow down for a few years. He may do so and be assured that while his income may be less, his decision should not affect his partners and they should not resent him. In a few years, the same partner may realize that the best thing for him is to bear down and generate more income for his children's college education and for his own retirement. This system allows that kind of increase or decrease in efforts and contributions because it only rewards success and hard work.

Under this system there is much less bitterness toward a partner who is perceived to be making less of a contribution to firm profitability because when they contribute less, they receive less. Of course a partner who performs well below normal expectations will still have problems. This person may, in fact, be asked to shape up or ship out. Tolerance will only go so far.

Seniority has no direct value in compensation under the modified Hale and Dorr system, though a more senior partner would probably bill at a higher rate and therefore command a larger percentage of the grinder share of the profits when doing the same amount of work as a younger partner.

An objective system such as this greatly reduces the amount of pie splitting animosity that can develop under other systems. Partners have a good idea of what they will earn by applying the formula to their statistics at any time during the fiscal year. The only variable is the discretionary pool. However, because the pool is relatively small and the outstanding contributions are usually quite obvious to all, few arguments and hostility result.

Weaknesses

The modified Hale and Dorr system does a good job of taking care of the billable time rewards. Unfortunately, no rewards are built in for non-billable time, except perhaps through the bonus pool (and that is not the purpose of such a pool). If *all* partners equally share *all* the non-billable activities required in a professional service firm, then there would be no problem with this type of compensation system. However, most professional service firms do not equally divide responsibility for firm management, training or mentoring of juniors, practice group leadership, recruiting or committee work. So where is the motivation to use time for these important aspects of running a profitable firm?

Given the choice, partners will always opt for the billable work ahead of the non-billable work. As a result, this type of system can create more a firm of individuals rather than a firm of team mates.This is *not* a contributor to firm collegiality. In fact, often the opposite is the result. Partners become so concerned with their personal numbers and income, little time or effort gets expended on the type of activities that build teams and collegiality.

In addition, because partners are paid only for their production, many make the mistake of hoarding clients and work. Their thinking is that 60 percent as the grinder is a lot more that 10 percent as the finder. This can lead to resentment by the other partners, and to liability risks when a partners perform work in areas in which they are not proficient. It is demoralizing as well to the juniors who are not getting enough work—or enough quality work.

THE SIMPLE UNIT FORMULA

The simple unit formula is designed to reward seniority, production, client generation and non-billable activities, using a relatively straightforward and totally objective calculation. A typical formula might be that each partner receives:

- one unit/point for each year with the firm
- one unit/point for $x of production (fees billed or fees received)
- one unit/point for $2x of client generation.

The non-billable units/points are awarded on the basis that the total available number of units/points is three times the number of partners. Then those available units/points are allocated on a pro rata basis for non-billable time recorded. Needless to say, when all of the units/points have been allocated they are converted to percentages and then applied to the net firm profit for the fiscal year to create each partner's individual income.

This system is not unlike the modified Hale and Dorr system in that it mainly rewards production in an objective manner. The biggest differences are that the simple unit formula also rewards longevity with the firm as well as some non-billable efforts.

Strengths

Simplicity is a key attribute of the simple unit formula. It is a straightforward calculation that most partners can readily understand and compute. And that is good! Remember the last truth at the beginning of this paper—K.I.S.S. (Keep It Simple Stupid).

The rewards under this system are for actual contributions in that it is a totally objective formula. Unlike most other objective compensation systems, however, the simple unit formula also takes into account seniority and non-billable time, at least to some degree.

Because production is at the heart of this scheme, there is less bitterness towards those partners who may be considered as under-producers or low profit contributors. These partners' rewards will be less when their production is lower.

"Unlike most other objective compensation systems, however, the simple unit formula also takes into account seniority and non-billable time, at least to some degree."

Probably the greatest strength of the simple unit formula is that it lives up to its name. It is simple! Every partner knows exactly what they have to do to earn the income that they desire and they know at what level all of the factors are weighted.

Weaknesses

The major drawbacks of the simple unit formula is that it can promote the hoarding of clients and files. Individual partners want to make their numbers and on a personal income level, there is little value in delegating work or clients. Obviously, a system that encourages hoarding results in less collegiality and the competitive focus can become internal rather than external.

The units/points awarded for seniority can cause some animosity among the younger partners as well. This may well become a serious impediment to lateral hiring since the new partners would start at zero points/units in the seniority factor compared to peers in the same firm.

THE 50/50 SUBJECTIVE/OBJECTIVE SYSTEM

The 50/50 subjective/objective system attempts to overcome the problems associated with systems that are too objective or too subjective. It recognizes that both types of criteria are valuable to the firm as a whole.

The objective part of the scheme is that 40 percent of partner income is based on actual billings or receipts, while 10 percent of income is based on actual client generation statistics. Please note that these percentages are not etched in stone and can be varied according to a firm's vision of what compensation should reward and what weight it wishes to give the individual criteria within its compensation system.

The subjective portion of the system is based on the perception of all of the partners of two other criteria. Ten percent of the subjective portion is based on the perception of a partner's client handling abilities and 40 percent is based on the perception of all other criteria. Again, these percentages can be varied to reflect a firm's goals.

In large firms where partners may not have enough knowledge to accurately rate some of their fellow partners in the subjective criteria, some firms have opted to leave that part of the plan in the hands of the specific departments or practice groups.

Strengths

With a large portion (40 percent) of the subjective portion of this system being allocated to almost any strength a partner brings to the table, there is usually a great deal less animosity and more collegiality within a department, practice group and firm. This purposely undefined share of income can be used to reward unusual non-billable efforts, firm management, training of juniors, mentoring, being a team player, attempts at client generation that do not materialize immediately, or for being a nice person and an overall asset to the partnership.

This same 40 percent also can be used negatively. Awarding a low percentage can send a message to a partners who are not perceived as positive a contributors to the overall firm—even though they may have very good *objective* numbers. It is in a partner's best interest to get along, because 40 percent of a partner's income will be based on the his or her partners' perceptions of overall contribution to the department, practice group or firm. Negative things that may be taken into account and thereby adversely effect a partner's income are: file or client hoarding, being too demanding of staff and juniors, not contributing to firm initiatives, not complying with firm policies, not taking the time to properly train juniors, or just being an all-around pain.

Many firms and partners like this type of system because it allows for individual partner input into compensation through the subjective portion of the plan. As mentioned, some large firms leave this portion of the calculation to the department or practice group—the people in the best position to evaluate another partner's overall subjective contribution.

For those partners who demand that compensation be tied to actual performance, one half of remuneration is based solely on the objective numbers for billings/receipts and client generation. Under this system, the objective factors are recognized more than in some of the other plans but less than in schemes that are more "eat what you kill."

In that partners allocate 40 percent of the subjective portion of income, the system can serve as a form of partner evaluation. This is especially true when an anonymous report outlines the considerations that the partners took into account when allocating the subjective share of the plan.

The subjective part of the system should also go a long way to overcoming the problem some firms face with file and client hoarding.

Weaknesses

The partners who dislike this system say that it does not provide a good enough idea of what it takes to make personal income goals. In addition, others argue against the subjective portion as being too "touchy-feely." They want a more objective scheme that ties bigger rewards to actual production.

There is the chance that some animosity may develop over the allocation of the subjective portion. The "Who do they think they are telling *me* what to do" syndrome can set in and become divisive if compensation decisions are not properly and positively conveyed to every partner.

There can also be less collegiality some level of animosity aimed at the partners who do not meet expectations on the objective side of the equation because they may have been able to overcome that shortfall with the subjective criteria.

Perhaps the biggest argument against this compensation system is that, if not properly explained and implemented, the subjective criteria might be seen to being open to manipulation to some degree when this facet of the scheme is not backed up by data, in some form or other like a partner peer evaluation system.

TEAM-BUILDING SYSTEM

This is the ultimate team system of compensation. Individual contributions are given little consideration while firm profitability and practice group or department performances are paramount. It is diametrically opposite any form of an eat-what-you-kill system.

The formula for the team-building system bases 50 percent of a partner's compensation solely on how well the firm does financially. Another 40 percent is based on a practice group or department's financial performance, and the remaining 10 percent is based on the individual partner's performance. These percentages can be varied to suit a particular firm's vision of what the weighting should be for each of the three areas.

Strengths

Simplicity may be the greatest strength of this system. What could be easier than just focusing on the firm and practice group or department doing well?

There is little pie splitting animosity because the system is totally objective and it downplays the role of the individual. All partners in a group or department will sink or swim based on their collective efforts.

The concept of putting "the team" ahead of the individual is a powerful way to promote firm goals. When everyone pulls together we all succeed to the highest levels. And, again, the competitive focus is external rather than internal.

Cooperation and collegiality at the group and firm levels are the cornerstones of a team-building system. This requires a partnership of individuals who are comfortable with one another, who have faith in one another to always do what is best for the team—to willingly waive individualistic tendencies when they conflict with the goals of the team.

Firms using the team approach seldom have file and client hoarding problems. Delegation is usually at a high level because it is in everyone's best interests to push work to the lowest competent level. This provides better value to clients, training for juniors, challenges in professional development and greater job satisfaction all around. In turn, those results have a positive effect on firm profitability, thereby perpetuating the system of teamwork. There is also greater cooperation between departments and practice groups because that, too, can help improve both group and firm profitability.

Weaknesses

Some partners may feel that there is a lack of recognition for seniority and experience. Unless there are levels of partners within the system, all partners would earn about the same amount. The only variable would be the relatively small percentage allocated base on individual production.

Some animosity may develop toward partners who are perceived as being the weak links in a department or practice group. That can also be a strength if a firm acts on the weak links by setting minimum standards for all partners—standards that do not tolerate lengthy periods of underachievement.

"Before you can develop a successful, comprehensive compensation system you must have a very clear and agreed to credo as to what makes your firm tick."

The individual large contributor may well leave in search of a firm that will reward individual efforts more highly. In fact, some argue that this system promotes a "lowest common denominator" approach. In other words, partners don't make enough of an effort because they don't see the direct rewards of doing so and don't feel they need to perform at a level above some of their partners.

EAT-WHAT-YOU-KILL SYSTEM

By contrast to the team-building system, the eat-what-you-kill system solely rewards individual efforts, with no recognition for anything beyond personal production.

One form of this type of system charges each partner a share of firm overhead, but each partner pays the salary of his or her secretary or assistant. Also, individual marketing, continuing education, personal technology and memberships costs are the responsibility of the individual partner. The time of juniors is "purchased" from the firm at set rates but charged out to clients at whatever billing rate the partner thinks is appropriate. Partners can also sell an interest in a particular file to another partner at a negotiated rate. (Typically, the client originating partner will get 10 percent of whatever is billed by the other partner.) Having dealt with all of the costs, the partner then gets to keep 100 percent of all receipts.

Strengths

Every partner has total responsibility for his or her income and clients—and partners know exactly what they must do to achieve the income levels they desire. There can be no blaming anyone else. The system provides incentives at various levels. First, the partners will want to bring in business for others because they get a percentage of the billing when they "sell" the file to another partner or when they get a junior to manage the file. There is also an incentive for hiring and retaining only profitable, hard working juniors so that they can maximize their own incomes. There strong motivation for partners to collect their receivables because it is their own money. Lastly, the firm will maintain tight controls on spending because partners will not tolerate too large an overhead allocation.

There is no pie splitting animosity because there is no pie splitting. Everything is dealt with at an individual level.

Weaknesses

Probably the greatest weakness is that, in most cases, there is a total lack of responsibility for managing the entity. Because no one gets recognition for non-billable time spent there is often a void when it comes to firm management, training of juniors, firm marketing or human resources. Eventually, that must lead to major problems and possible disbanding of the firm.

The system creates no need for collegiality other than as a method to market other partners for work for their clients. Often partners don't even talk to their colleagues unless they have a financial or personal reason to do so. That, in turn, spreads throughout the firm, creating a very difficult environment for most staff, juniors and even some partners to work in.

Some firms using this system have problems with the work-sharing aspects. Some partners may choose to not work for another partner's clients for myriad reasons, leaving the originating partner to fend for him or herself in an area in which they may lack proficiency.

There is a definite hoarding of files and clients—that is what the system is all about. Sometimes this is to the detriment of the client. There are few "common good" factors at work because the individual good is paramount.

There is also little or no training of juniors because it is almost valueless under this system. Juniors find themselves in a sink or swim situation right from the start.

CONCLUSIONS

Are you wondering which, if any, of these systems would work best for your firm? As a starting point, you might try answering the question, "What do we value most?" Before you can develop a successful, comprehensive compensation system you must have a very clear and *agreed* credo as to what makes your firm tick—and a clear understanding of why this is the case.

Before exploring change, you must also gain a true reading of what your partners do and *do not* want in a compensation system. It can be very helpful to ask an outsider, someone with no hidden agenda or compensation baggage, to facilitate a brainstorming session among the people most affected: the partners. You may be surprised how agreeable your partners are once they have made their points of view known and considered the points of view of their colleagues.

No matter which compensation system you choose, remember these basic truths:

- There is no "magic" system.
- Compensation can not be legislated.
- Some of your partners will not like whatever you decide, no matter what it is.
- Relate the compensation system to the firm's strategic goals wherever possible.
- Try to get an understanding among your partners of the need and value for rainmakers, client minders and grinders. They need each other to be successful.
- Directly involve the people most effected: your partners.
- K.I.S.S.—Keep It Simple Stupid.

Michael Anderson has spent more than 25 years in and around professional firms throughout Canada (Toronto, Edmonton and Vancouver). Additionally, he has been a consultant to firms throughout North America since 1987. During that time he has been involved in every facet of firm management, marketing, administration, governance, partner compensation and strategic planning.

Altman Weil, Inc.

Report to Legal Management

March 2003
Volume 30, Number 6

OUR 29TH YEAR

Marketing, Origination and Formulaic Law Firm Compensation Systems

Alan R. Olson

By Alan R. Olson

Editor's Note: This is the first of a two-part series on law firm compensation systems. The second installment will appear in next month's issue.

With the increased importance of marketing in the universe of law firm priorities, incentivizing and rewarding marketing in law firm compensation systems is receiving more and more attention. The table on page 3, taken from the Altman Weil *2000 Law Firm Compensation System Survey*, shows that business origination was the most important compensation factor, in a virtual tie with (but edging out) personal fees collected. See the first and last rows (the lower the number the higher the ranking). In the Altman Weil *2003 Law Firm Compensation System Survey*, due out shortly, we expect that business origination will hold a similar ranking.

In this article, we will explore the interrelationship of marketing, origination and formulaic (a/k/a objective) compensation systems. The goal is to provide a representative overview of the treatment of marketing by formulaic compensation systems, ranging from pure formulas to less rigid, but still fundamentally objective, systems.

Measurements — Converting Marketing to Origination to Compensation

Formulaic systems involve the use of one or more mathematical calculations to derive a credit, a percentage or a dollar figure that results in compensation distributions or divisions. Therefore, to understand formulaic law firm compensation systems, it is necessary to first focus *on the need to convert activities and behaviors into numbers that can be measured and calculated, to form the basis of a currency.* While this is particularly true of formulaic systems, it is also applicable to subjective compensation systems in law firms.

Working Attorney Collections

Working attorney collections, which measure the collections received for work that a lawyer performs him- or herself, can be used to measure marketing or business origination, but only generally. Unless a law firm is comprised of very independent practices, like an office-sharing group of lawyers each of whom personally serves the clients

continued on page 3

Inside This Issue

Marketing... *continued from cover*

he or she brings in, lawyers will be developing some legal work that they distribute to others and do not perform personally. And, lawyers *should* be developing work that they distribute to others and do not perform personally — that is a major reason for specialization, for teamwork and ultimately, for having a law firm in the first place.

Billing Attorney Collections

"Billing attorney collections," which measure the collections of the clients that one is responsible for billing, are more on the mark in rewarding marketing and origination than working attorney collections. In many cases, the lawyer billing the file is also in fact responsible for the overall client relationship, and that may well have derived from bringing in the client in the first place. Many lawyers will refer to billing attorney figures as a "book of business," with the inference that if you bill it, it's your "book." Some firms measure personal working attorney collections and billing attorney collections and call it a day.

If a firm is trying to maximize its marketing performance, however, relying on billing attorney credits to measure marketing falls short. To perform optimally, lawyers in a firm must cross-sell other lawyers and practice groups to prospects and clients. The need for cross-selling to maximize performance increases with a client's breadth of legal service needs and sophistication. This increases the likelihood — and one could argue, the necessity — for sending billing responsibility away from the initial rainmaker to the person actually responsible for the work, at least in many situations.

Some firms handle this by developing an additional "responsible attorney" category, crediting lawyers who are actually managing the matter, and sometimes, *de facto* managing the client. To some extent, this allows the billing attorney category to more closely resemble a combined business developer and book of business category, which is a hybrid more closely resembling origination.

Origination Collections

Simply put, "origination" includes the development of business for the law firm. While the term connotes creation, as in new business, it can be tricky in practice. Some firms reward origination essentially in perpetuity, whereby a client developed 30 years before may still lead to the lawyer's being rewarded with origination credits for compensation purposes. In some firms, clients and origination credits can actually be passed from one lawyer to the next, even after many years. In such arrangements, the distinction between origination and billing attorney, or book of business, greatly diminishes. More importantly, rewarding origination in perpetuity can work against the firm's best interests over time, because individuals may focus too much on tending their existing gardens (or sometimes, on ingratiating themselves as potential heirs), and too little time on hunting and gathering new business.

New Business Origination

In new firms, or when a system rewarding business origination is relatively new to a firm, there is better rationale for considering all origination dollars more or less equally, and the negatives from origination that has gotten too old have not typically risen to a level of concern. At some point, however, firms tracking and compensating based on origination will at least wrestle with whether or not to differentiate between new business origination and older business origination.

Defining new versus older business can be difficult. An approach applied by Altman Weil in some firms involves imposing a "sunset" on all new business, typically two or three years after client acceptance or first billing date. At that point, either new business credit ceases, or is reduced. Other compensation credits, such as billing attorney credit and working attorney credit, would remain in most systems and can ease the abruptness of the reduction in new business credit. Of course, as described above, the new business originator should not always be the billing attorney in many kinds of practices, or the working attorney either.

Figure 1

Rank importance of each compensation factor in determining owner compensation.	Size of Firm								Total	
	2 to 19 Lawyers		20 to 49 Lawyers		50 to 99 Lawyers		100 or More Lawyers			
	Mean	Median	Mean	Median	Mean	Median	Mean	Median	Mean	Median
Business origination	3.4	3.0	2.9	2.0	2.4	2.0	2.1	1.0	3.0	2.0
Case responsibility	5.6	5.0	5.3	5.0	4.4	4.0	4.6	5.0	5.2	5.0
Client responsibility	6.0	6.0	5.0	5.0	4.2	4.0	3.7	3.0	5.3	5.0
Community involvement	10.3	11.0	10.8	11.0	10.7	11.0	10.6	11.0	10.5	11.0
Contribution to firm management	6.6	6.0	6.4	6.0	6.9	7.0	6.5	6.5	6.6	6.0
Cooperativeness	8.4	8.0	9.2	10.0	9.5	10.0	8.6	8.0	8.8	8.0
Legal expertise	6.2	6.0	6.5	7.0	6.8	7.0	6.5	7.0	6.4	6.0
Professional involvement	11.1	12.0	11.3	12.0	11.2	11.0	11.7	12.0	11.2	12.0
Relative ownership percentage	7.6	7.0	9.8	12.0	10.1	12.0	10.7	12.0	8.8	11.0
Seniority within firm	8.5	10.0	8.4	10.0	10.8	12.0	10.0	11.0	8.9	10.0
Seniority since first admitted to bar	11.7	13.0	10.9	12.5	12.1	13.0	12.4	13.0	11.6	13.0
Work done, hours recorded	6.0	5.0	5.2	4.0	5.8	5.5	5.4	5.0	5.7	5.0
Work done, personal fees billed	6.1	5.0	5.4	4.0	6.0	5.0	6.4	5.0	5.9	5.0
Work done, personal fees collected	3.3	2.0	2.5	1.0	2.6	2.0	4.1	3.0	3.1	2.0

Respondents ranked responses "1" for most important to "14" for least important.

continued on page 4

Marketing... *continued from page 3*

Differentiating *new* business origination is helpful in reducing the problems described above, when working attorney credit or billing attorney credit is being stretched to fit new business. Adding a new business origination factor, however, which is often complex in itself, establishes another layer of complexity to a compensation system. Exceptions to two or three year sunsets can be made for practices with contingency fees and those with intermittent collection patterns, such as probate. Differentiating between institutional clients and litigation practices can be more difficult. The exact approach to distinguish between new business origination and origination or billing attorney credits often depends, in part, on the firm's practice mix and relative practice diversity. The effectiveness of the solution not only depends on practice mix and practice diversity, but perhaps even more critically on the firm's mixture of rainmaker and lawyer personalities.

Marketing Efforts

Many believe that marketing efforts, not just dollars originated, can and should be measured. Relative to formulaic systems, this is a short discussion, since marketing efforts will be viewed subjectively. Relatively often, non-billable time devoted to marketing will be considered, but very seldom in a formulaic manner, where a calculation is used to derive a percentage, credit or dollar figure.

Examples of Formulas, Origination and Marketing

Following are eight examples of formulaic (objective) law firm systems. Each of these approaches considers marketing or origination on some level, or it can be argued that it does so. Each of these methods has been observed or applied in law firms and would be pronounced effective by some significant constituency.

1. Divide the Pie Equally

The equal division of net profits, often referred to as "dividing the pie equally," does not expressly consider marketing — nor does it expressly consider legal work performed, business managed, management of the firm or any other factor — except the "we are all in this equally" factor. While there are benefits to the approach, including ease of administration and promotion of a positive "all for one and one for all" attitude, it is not surprising that fewer and fewer profit pies are being divided equally in law firms.

2. Seniority-Based Lockstep

The seniority-based lockstep system is formulaic in application, and in its pure form does not consider marketing. As the name suggests, a seniority-based lockstep system generally rewards an individual's years as a partner or shareholder with the firm or — infrequently — rewards total years with the firm or years in practice.

"... seniority lockstep systems have tended to continue increasing individuals' compensation until they retire, which does not typically track with lawyer performance norms."

While marketing is not the equivalent of seniority, there often is some correlation. In many firms and in many careers, the individual's marketing effectiveness and results do increase with seniority. In general, lawyers do better at rainmaking and in other performance-based factors as they become more senior. In practice, however, most seniority-based systems function as too blunt an instrument, failing, by definition, to differentiate between individual performance levels in origination, either within the same seniority tier or between tiers. In addition, historically, seniority lockstep systems have tended to continue increasing individuals' compensation until they retire, which does not typically track with lawyer performance norms.

3. Simple Division

In this system, working attorney collections are tracked by individual lawyer, typically throughout the partner group. This simple system assumes that individual collections are equal to business developed, and that partners trade collections for work developed and distributed to other partners.

Calculate:
Individual's collections divided by total partner collections x 100 = individual's percentage of the profits.

Example:
Partner A @ $250,000/Total Partners @ $1,500,000
Equals .167 X $750,000 (assuming 50% net profit)
Equals $125,250 in total compensation

The strength and weakness of this system is its simplicity. It is more suitable for office-sharing firms, however, as it doesn't provide for teamwork, and is likely to result in bartering.

4. Simple Formula With Origination Pool

In this example, 25% of all net profits are allocated to an origination bonus pool. A calculation is made using reported origination collections by lawyer.

Example:
Partner A @ $300,000 origination divided by total origination of all partners ($1,500,000) = .20 X $187,500

(origination bonus pool — equals 25% of assumed $750,000 net profit). Equals Partner A bonus of $37,500.

This system is still quite simple, but differentiates between origination and other performance factors. Origination collections must be tracked by partner, and at least eventually, the question of new versus older origination will likely surface. The origination pool requires reasonably good budgeting by the firm, and a funding mechanism. Note that this system is slightly more complex than the preceding one, at least on paper, but that a single additional layer of complexity may increase the number of implementation issues geometrically.

5. Weighting New Versus Existing Business Origination

This approach is a variation on the "sunset of new business" concept: credit for *new* business origination is greater than for *existing* origination. For example, each new client matter will be given a double credit or double weight for the first three years, after which the new business half of the credit is sunsetted and the origination reverts to a single-weight credit. The credit or compensation amounts can be derived by calculation, as in the preceding bonus pool example, but results in weighting toward new business, i.e., rewarding and incentivizing hunting for new business over farming of existing business. This system requires more complex tracking, but is achievable with most modern accounting systems.

6. Formulas Based on the Hale and Dorr Method

This well-known formulaic approach to law firm compensation was developed in the law firm of the same name. Examples of variations on the original theme are usually seen:

- Each dollar of revenue collected is divided into two components: 70% working attorney and 30% originating attorney; or

- Each dollar of revenue collected is divided into three components: 70% working attorney; 20% originating attorney; 10% billing attorney; or

- Each dollar of revenue collected is divided into four components: 60% working attorney; 20% originating attorney; 10% billing attorney; 10% responsible attorney.

"... rather than employ a cookie-cutter solution, a law firm's compensation system must be tailored to meet the needs of the particular firm."

The individual's share is applied to firm profits available for distribution to derive actual individual compensation amounts.

7. Rolling Average

This system calculates origination by individual lawyer, but on a rolling-average basis — for example, the average of the last three years' performance. This method can prevent wide swings up and down, and can be applied as a retrospective calculation for the concluding year, as in a retrospective bonus pool, or be applied prospectively, to calculate a portion of an individual's base compensation or base compensation percentage for the upcoming year.

8. Rolling Weighted Average

The rolling average can be weighted, for example, by giving a double-weight for the most recent year, on an ongoing basis. This increases the weight on most recent performance, while still helping to smooth out peaks and valleys of performance.

Rolling average and weighted rolling average methods can be more significant for practices, or for firms, having incidence of feast and famine workload swings, or a mixed contingency fee practice.

Conclusion

As the legal market becomes ever more competitive, stimulating and rewarding, marketing and origination has been increasing. Formulaic law firm compensation systems respond to this by seeking to convert marketing into some kind of currency, usually origination dollars or credits, and to convert the currency, through calculations, into individual compensation dollars.

An overview of measurement methods and a range of formulaic approaches to handle origination — some rather passively, others aggressively — have been described. None of these systems should be considered in a vacuum, or simplistically pounded into an existing compensation system without careful analysis and reflection. Often, in law firm compensation, an action has much more than an equal and opposite reaction.

These compensation system descriptions are not an endorsement, beyond recognition that the systems have been implemented effectively by law firms. In fact, rather than employ a cookie-cutter solution, a law firm's compensation system must be tailored to meet the needs of the particular firm. More often than not, Altman Weil consultants recommend subjective, or mostly subjective, systems in law firms, rather than formulas. ◆

Alan R. Olson *is a principal of Altman Weil, Inc. He can be reached at (414) 427-5400 or* arolson@altmanweil.com.

Cameron's Profits for Partners Blog

A discussion of practical & innovative ways to increase profits for law firms

Trends in Partner Compensation Systems in Law Firms

Posted on May 11, 2011

An increasingly competitive legal environment is resulting in changes in the way that law firms pay their partners.

In my experience there are three main types of partner compensation systems:

1) Equality/lockstep – Compensation is determined mainly by seniority. I've seen this system used by many small firms and some very large US and UK firms. The advantage is that it encourages partners to work as a team, while the disadvantage is that partners may not feel it's fair if other partners don't pull their weight yet are paid the same as high performers. This can lead to a lack of incentive for high performers, and creates a risk they may leave.

2) "Eat what you kill" – Compensation is determined mainly by personal production. This system is used by small and midsize firms. Objective systems like this usually focus on just the numbers, which makes it clear to all partners what the expectations are, and is fairly simple to determine compensation as a result. The downside is that these objective systems also encourage partners to "game" the numbers to their own advantage. This can lead to breakdowns in team-building, where partners act as "lone wolves" and talk about "my clients", not firm clients.

3) Subjective Merit – Compensation is determined by subjective analysis supported by objective factors. It usually involves a compensation committee of 3 or 4 partners, and is used mainly by midsize and large firms. This system has the advantage of encouraging partners to operate at a higher level and get compensated accordingly. In addition, the subjective merit system may have an objective component as a starting point, but subjective analysis reduces the potential for "gaming" the system in a purely objective formula system.

Depending on the culture of the firm, any of the above systems may work effectively. However, my experience and research indicates that the most effective system for increasing profits is the subjective merit compensation system.

Compensation System Trends

One of the major trends I see is towards more "pay for performance" in law firms, with a particular emphasis on rainmaking results. Rainmakers are paid big bucks to switch firms, especially commercial lawyers who are able to command and move a large client base.

Compensation compression ratios (the $'s paid to the highest paid partners compared to the lowest paid partners) are increasing, as firms accommodate rainmakers at the top end of the pay scale.

Law firms are requiring an increasing minimum practice size to remain as an equity partner.

Non-equity partnerships are growing in popularity as firms attempt to maximize their leverage and equity partner compensation.

Large firm compensation systems are becoming more "corporate" in nature, as firms grow in size and scope internationally. The larger the firm, the more corporate the model. Managing partners and executive committees are wielding more power, and are providing more input to the compensation of individual partners, who are becoming more like employees in large firms.

Managing partners and practice group managers are being compensated more for their management accomplishments. Some firms are compensating their managing partners using balanced scorecard techniques, for example. Law firms are trying to run like real businesses, and are delegating more and more of the firm's business functions to their management partners.

Many firms are requiring pre-retirement phase-downs in compensation and have established retirement policies at a set age eg. 65. There is some controversy here, however, given challenges to the legality of forced retirement. Firms are continuing to try to enforce these retirement policies in order to maintain increasing equity partnership leverage and profitability objectives.

There is a trend for senior partners with portable practices to move from firms where they have spent their entire careers, after being forced out by the imposition of set retirement age policies.

Most firms have fairly “open” compensation systems, where partners know what other partners are being paid. The trend is towards less compensation transparency in larger firms, however, with power and information centralized within a few management partners. Compensation discussions can be too much of a time distraction for large firms.

More non-equity compensation arrangements are being used for hiring lateral partners and retaining good “up and comers” with long-term potential for building a practice.

Buy-in requirements are growing as firms grow and partner leverage increases.

More flexibility for balanced lifestyles and part-time partner arrangements are being demanded and received by the new generation of partners.

Compensation Criteria Trends

There is more emphasis on teamwork, and less emphasis on personal billable hours. This also ties in with growing recognition for the need to lever work, and the growth of alternative billing practices.

More firms are doing strategic plans in response to increasing competition, and this is leading to a need to recognize partners’ non-billable efforts in implementing strategic plans at the firm, practice group and individual partner levels. This also means more recognition of training, supervision, quality control, and various other non-billable tasks performed by partners.

More firms are recognizing client origination results, and firms are tracking client and matter origination more diligently. Sales skills are being taught to partners and associates.

More peer evaluation is happening, especially in larger firms. There is also more emphasis on client feedback, realization and profitability of partners’ practices. More emphasis on cash in, and less on billings.

Compatibility with firm culture is becoming more important. Non-conformists with firm culture are punished, leaders are rewarded.

Summary

The key trend is toward more “corporate” compensation models, driven by competition and the corporate style of growth of large national and international firms. Compensation is driven more by the strategic goals of the firm, and partners who contribute to firm goals are compensated at higher levels as a result. There is more and more emphasis on pay for performance as well.

Compensation compression ratios are widening, as firms attempt to accommodate and retain the rainmakers in their firms. This has resulted in major dollars being spent to lure new rainmakers to the large firms. Business development is more and more highly prized, and rainmakers’ compensation is increasing significantly.

The danger of a very high compensation compression ratio is that you could end up like Finley Kumble a few years ago. They hired many rainmakers and paid them exorbitant dollars for their client originations without a sunset clause, and the whole firm came crashing down as a result. Several different factors were involved, but the extremely high compensation compression ratio was pointed to as a major factor in their demise.

Firms are also trying to encourage partners to lever more to others, and in the process institutionalize clients so that it is more difficult to move clients when partners are offered more money by other firms to lure them away. Buy-in requirements are rising as firms lever more and reduce the % of equity partners relative to non-equity partners and associates.

Large firms tend to favor subjective merit systems, while smaller firms tend to favor more objective systems. Large firms are increasingly profitable, and the gap is widening, so there may be some correlation/cause/effect in the use of subjective merit systems which leads to increased profitability.

Related articles

- Win-Win Alternative Billing Strategies – Part III (lawprofitability.com)

This entry was posted in **Firm Governance**, **Law Firm Strategy**, **Partner Compensation**, **Profitability** and tagged **Business**, **Equity partner**, **Law**, **Law firm**, **law firm profitability**, **Law Practice Support**, **Lawyer**, **Lockstep compensation**, **partner compensation**, **Services** by **Colin Cameron**. Bookmark the **permalink [http://lawprofitability.com/2011/05/11/1019/]** .

JOEL A. ROSE & ASSOCIATES, INC.
Management Consultants to Law Offices

Dealing with Tensions Surrounding Partner Compensation

by Joel A. Rose

Partner compensation is invariably the topic of most interest in every law firm . It is also a topic which involves the most fervent debate and encompasses the most varied points of view. Not surprisingly, partners will normally advocate a compensation system which most favors their particular strong points as an attorney. Partners who do not generate much of their own business, but have high billable hours, obviously promote a system based upon billable hours only. Partners who tend to bring in a great amount of "rain" and allow it to be serviced by others, normally would promote a system based solely upon origination.

One of the biggest concerns in structuring a compensation system for a law firm is to avoid creating a firm which is essentially a group of solo practitioners sharing office space. A firm seeking long-term success must recognize that all partners bring strengths and weaknesses to the process of creating revenue and the firm must balance the various needed contributions of partners to create a fair compensation system.

A firm cannot be composed of solely attorneys who develop business without any attorney that can service it. Not can a firm be composed of attorneys with administrative skills without actual business to administer and oversee. A firm solely staffed with productive attorneys will soon run out of work if business is not brought in by at least a significant percentage of partners.

Issues Surround Origination:

There are different kinds of origination: An attorney may be successful in developing business solely from a new source that has not previously been associated with the firm. On the other hand, the firm may have long standing clients whose business has been greatly expanded by a particular partner or group of partners. Obviously, both types of origination have value for the firm.

The presence of the firm itself does play a role in origination: While some clients and many attorneys, particularly heavy rainmakers, like to stress that clients hire attorneys and not law firms, the fact remains that a certain level and scale of work would not be able to be performed or serviced by a solo practitioner. Invariably, the size, resources and reputation of a law firm do play a role in an individual partner's efforts to obtain or expand business. As an example, a solo practitioner would not be in a position to obtain and handle business consisting of a large volume of liability claims for a self-insured corporation. Substantial corporate transactions could not be handled by a solo practitioner. The resources of the firm must be a consideration.

Basing compensation solely on origination: There are obvious dangers to a pure formula based upon origination. First, it discourages partners from working on business developed by other partners even when they are more suited for handling that particular case. It discourages partners from giving support to marketing efforts of others and, most importantly, fails to reward partners who maintain a client originated by another or provide the administration or servicing of that client. At some point, the line becomes blurred between a partner that originates the work and the partner or partners that are maintaining the work and providing quality representation that keeps the client coming back. There is also a point over a period of time in which a client moves from being a client originated by a partner to being a firm client because of the amount of contacts from other attorneys in the firm over the course of the year. This pure origination formula fails to reward good lawyering performed by attorneys who have not brought any original business and fails to look at the administrative needs of a law firm.

Origination vs. Personal Production:

Formulas considering both origination and production must consider the particular structure of the law firm and the nature of its practice: For example, a law firm specializing primarily in insurance defense litigation and operating at a much lower hourly rate can readily afford the luxury of having highly compensated partners who merely originate business without having significant billable time. In firms in which hourly rates are much higher for such work as labor or corporate transactional work, the firm may have the luxury of highly compensating partners who are primarily rainmakers. The first step is to look at the structure of the firm and the nature of the practice.

Personal production mut be recognized and rewarded: Successful rainmakers are ultimately only successful if they are supported by highly competent attorneys who can do the work, produce the results and keep the client happy. Many of these attorneys may be very skilled, but not have particular strengths in marketing and business development. Ultimately, a firm must recognize the need for both types of attorneys and develop a formula which recognizes and compensates attorneys not only for business origination, but for client service, skill level and results in actual case handling. The ideal partner who ultimately should receive the highest compensation is the attorney who is able to bring in significant work and also do that work at a highly competent level with great results. These are the individuals who will emerge as stars of the firm. Putting the stars aside, all partners must realistically develop some level of business or their earnings will be capped. All partners must also recognize the need to service business as well as develop new client sources.

Doing the work or referring it: A compensation formula that encourages a partner to perform all work that the partner brings in personally and discourages referral to other attorneys in the firm is ultimately shortsighted and leads to problems. First, partners cannot be discouraged from referring work to other attorneys in the firm. Particularly in terms of lower paying hourly rate work, such as insurance defense, profit is limited unless the work is leveraged by using other attorneys, particularly associates. By encouraging work to solely be performed by the originating partner, there is an obvious cap to the amount of work that can be performed and developed by the particular partner. Discouraging any contact from another attorney in the law firm for a particular client ultimately leads to a divisive legal practice. It is, quite simply, the antithesis of the proper operation and attitude of a law firm and ultimately leads to the situation where solo practitioners share office space and some expenses.

A commitment to business development: A compensation plan based solely upon billable hours fails to recognize both the value and absolute need for business development. Firms which are dealing with lower hourly work must, of course, set and maintain billable hours requirements. On the other hand, marketing efforts over and above billable production must also be recognized and rewarded. If the work is not brought it, billable hours will obviously become non-existent.

Firm management vs. personal production: Managing partners or other attorneys with administrative responsibilities may often have a difficult time producing the same billable hours as attorneys without such responsibilities. Again, the nature of the law firm practice must be considered. Firms dealing with high volume civil litigation practices may find it difficult to have the luxury of a managing partner with full-time administrative responsibilities and no billable requirements. On the other hand, firms doing work at higher hourly rates may feel that a managing partner who does not have personal production requirements is a necessity. It must be considered, however, that attorneys performing administrative duties must be wary of giving up all ties to their personal practice since they are obviously giving up a certain amount of leverage and power within the firm by doing so. On the other hand, attorneys producing significant billable work and also performing administrative duties should justly receive additional compensation for those duties.

Evaluating revenue based upon profit margin: Obviously, certain practice areas are more highly profitable because of the level of hourly rates or the lucrative nature of the particular types of files. Other work may be less profitable on a per attorney basis, but can be highly profitable if leveraged using lower paid associates. In order to properly analyze the profitability of business being generated and administrated by a partner, it is necessary to factor in salaries, overhead and additional costs per attorney, as well as administrative costs for marketing in other related matters into the practice to determine whether it is truly profitable. Obviously, partners should be better compensated if they are creating work with a higher profit margin. On the other hand, to take an extreme example, a partner cannot be expected to be paid $500,000 if he generates $750,000 work of work which costs the firm $300,000 to generate before his draw is even paid.

Is There an Ultimate Solution to Setting a Partner Compensation Formula?

The obvious answer to this question is "no." There are no absolutely fair partner compensation formulas. Compensation cannot ultimately be formulaic in nature, but must consider a number of factors on an individual basis.

Formulas based solely on originations can be disastrous and lead to disgruntled partners who are servicing clients generated decades before by a partner with little contact. Compensation solely favoring rainmakers creates dissatisfaction and turnover by partners who are actually handling the work and producing the results. There are very few firms in which areas of data can simply be input in a neutral manner to arrive at a perfect formula for a draw.

It is suggested that all the factors discussed above must be given weight and balance to arrive at a fair formula. A great trial lawyer who does not bring in business directly, but handles the most difficult cases, produces the results, and achieves a national reputation, has great value and plays a great role in bringing in business, albeit through an indirect process. A firm with many excellent, high paying clients can still falter if it is not properly managed and administrative skills of the managing attorneys are not recognized. A truly integrated law firm recognizes the need for many different types of attorneys in order to complement one another.

There is no perfect formula and setting fair compensation will always be difficult. It is essential, however, to factor in origination in rainmaking. The firm must recognize the partners who have significant billable hours, to acknowledge and reward partners who have developed a reputation or skill level to better service clients, to set a formula which recognizes and rewards marketing efforts, as well as billable hours, and to look at an analysis of profitability in the type of work being generated by particular partners. It is a difficult balancing act, often subject to adjustment and compromise, and one that must be tailored by the nature of the practice. All of the factors discussed above are important to the operation of a healthy law firm and all must be recognized and compensated in an appropriate manner.

RETHINKING PARTNER COMPENSATION CRITERIA

HOWARD L. MUDRICK

"You get what you pay for" may be one of the oldest truisms in the annals of compensation management. With good reason. It seems that no matter what system firms devise for setting compensation, those who are subject to it will figure out the "rules" and adjust behavior so as to maximize the value received. If the rules are poorly set, the organization ends up with inefficient and often problematic allocations of its human resources. This problem is particularly acute when applied to law firm partner (or shareholder) compensation systems. For many firms, the idea of "managing" the partners themselves seems foreign -- they are, after all, "partners." However, with limited management ability to affect behavior, and compensation systems which reward the ineffective allocation of resources, it is little wonder that many firms find themselves struggling for economic stability.

This issue does not just relate to the structure of the system, i.e. "objective" formula systems versus "subjective" systems, although the latter do give management at least some control over compensation setting and thus behavior. Many discussions of the relative merits of these two compensation approaches are available. Rather, the issue is one of what should be rewarded. This article will focus on the criteria used to set partner compensation, and the challenges and limitations of some of those criteria.

Historical Context

There are at least as many partner compensation systems in existence as there are law firms. And, it seems as though every system emphasizes different criteria, or similar criteria to differing degrees. However, historically, most firms emphasized one or more of three primary factors in setting compensation:

Seniority

Many firms once used a lock-step or modified lock-step approach to partner compensation. As partners became more senior, they automatically moved up the compensation ladder. Few complained, because everyone took their turn at higher compensation levels. Because partners rarely, if ever changed firms, there was little risk of partners defecting for more money. Circumstances, of course, have changed, and lock-step compensation systems have become a problem for many firms.

Lock-step systems today work well only under certain limited conditions. The firm must have a strong and usually institutional client base. It must have strong economic performance relative to the market in which it competes. It must strictly control partnership admissions. And, the firm must be willing to deal with unproductive or under-productive partners quickly and effectively. It is no surprise that such systems rarely work today. Few firms now claim they have a seniority based or lock-step approach to compensation.

However, many of the compensation system problems firms face result from the residual effects of seniority based systems. While a firm may claim to reward other things, in reality it clings to a system which rewards partners for longevity. Partners assume their incomes will increase and few partners ever take cuts. This results, over time, in a default seniority system. Often, it takes a radical change in the firm culture before a true break with the past can be achieved. Without such a break, the firm will often languish, unable to compete effectively because it fails to reward real contributions.

"Origination"

Nearly all firms, except those that base compensation solely on seniority, reward business generation in some manner. This is and will remain appropriate, as long as it is handled properly. After all, any business organization must have sales to survive, and most companies have learned that rewarding top sales persons is well worth the expenditure. However, in law firms, sales data -- called "origination" -- is the single most difficult statistic to judge accurately. In fact, almost any quantification of origination in a law firm is "wrong" in that it will not reflect accurately the relative contributions of partners to the development of the firm's business. As a result, almost any formula system which includes origination without some subjective adjustment will produce skewed results.

The problems are many. First, origination is often extremely difficult to assess. Therefore, most firms use some proxy, typically billing responsibility, which is often a very poor proxy for origination. Usually, only one lawyer will be responsible for billing, but many partners contribute to bringing in and maintaining a client. In the case of some institutional clients, very little origination value can be attributed to the billing lawyer. The partner is one of a number of partners responsible for servicing the client, which was actually "originated" by some now retired (or dead) partner. Unless the firm adjusts numbers for the various contributions partners make, compensation will inevitably be unfair.

Second, origination tends to have a lifetime value in many firms. No matter how long a client remains with a firm, the lawyer originally responsible continues to get the credit. This can result in perverse behavior. For example, partners in some firms register every public company somewhere in the firm's accounting system, just in case the firm ever does business with the company. Third, specific assignment of credit may reduce partner willingness to team-market. In some firms, partners are not even willing to work on other partners' projects unless they receive some of the credit. Of course, this leads to accounting nightmares and worse. The end result of many compensation systems which consider origination mechanically, is a firm which is little more than a collection of solo practitioners. While business generation is critical, it is important to judge each partner's total contribution to the firm's business base.

Finally, the firm should consider the profitability of the work. If a firm values only the volume of work, it will inevitably end up with a substantial amount of unprofitable business. Many firms today find that the clients of the firm's biggest rainmakers are unprofitable or marginally profitable. Like the tailor who "loses $10 on every suit but makes it up in volume," the law firm actually sees its profitability erode as its revenues grow. Although few firms today directly consider the profitability of the work in setting partner compensation, the number that do is growing.

Be careful not to overpay for business development. This is not to say that those who bring in substantial business shouldn't be rewarded. They should, and very well. However, it is easy to overestimate the value of sales. Most successful rainmakers are also hard working lawyers. As a result, their compensation packages reward both their rainmaking success and their hard work, among other things. Lawyers at the top of the firm's compensation scales are generally strong in both areas. Many firms have experimented with the "pure rainmaker" -- the lawyer who does not bill hours but is paid a substantial amount to make rain. In most cases, often involving former political figures, the firm ends up frustrated and overpays for whatever business the lawyer brings in. In this situation, other lawyers, including partners, must be compensated for performing and managing the work. Often a reasonable "cost of sales", which should cover both the rainmaker's compensation ("commission") and the overhead it takes to support him or her, will not justify what is actually paid to these lawyers. Law firms can take an important lesson from corporate America in evaluating these situations.

Personal Productivity

Firms compensate partners for the work they do personally. This is clearly appropriate, and the goal is to reward and encourage hard work. In practice, this has often focused on the partner's billable hours. There are a number of problems with such a focus.

First, focusing on billable hours alone fosters a variety of problems, including work hoarding which results in poor delegation, write-offs, and sub-optimal leverage, and over-recording of hours which has obvious implications for the firm and for clients. Second, focusing on hours alone tends to ignore the economic value of the partners' practices. Billing rates in some practices are far lower than in others. Should a partner be penalized just because he or she practices in an area with lower rates? Many firms struggle with just this question, which leads to internal conflict between the strong and weak practices. Unless resolved, the firm faces loss of its strongest practices, not its weakest.

Economic necessity requires that firms consider practice value when setting partner compensation. Thus, while hours are still considered, many firms now consider the amount realized from the partner's personal work. This, of course tends to give more value to work done at a higher rate.

A third problem with too heavy an emphasis on hours is a sub-optimal allocation of time to marketing, management and other firm building activities. In effect, the firm rewards short-term performance at the expense of the long-term.

Business development and personal productivity remain the two most important elements of most partner compensation plans. This is unlikely to change quickly and, as long as the factors are considered in light of the issues discussed above, this is appropriate. But to compete successfully in the future, a number of other factors should be considered.

New Performance Criteria

Other than seniority, the criteria discussed above are relatively short-term in nature. Perhaps even more than other American businesses, law firms have been guilty of managing for the short-term. Even the accounting systems in place emphasize only short-term performance -- hence the end-of-year push for collections in most U.S. law firms. If firms are to remain competitive in the long-term, they must reward performance that contributes to long-term success. Business origination and personal productivity will not, and should not, go away. However, a variety of additional factors must begin to play a greater role in law firm compensation systems. In most cases, firms have paid lip service to these factors for some time, but until recently, little more has been done.

Client Service

Perhaps nothing is more important to the future success of a law firm than its level of client service, and each client defines service differently in light of his or her own expectations and desires. Successful partners find out what their clients' expectations are and exceed them. Partners who provide such service should be rewarded, because it leads to a continued relationship with the client.

The only way to really know what clients think about the service delivered by partners is to ask them. Some firms -- still far too few -- are beginning to factor client comments about partners into their compensation decisions. These firms generally have well established client assessment programs which regularly gather information on client satisfaction on a variety of issues. Eventually, most successful firms will base partner compensation decisions at least partially on client feedback.

Quality of Work

Surprisingly, many law firms have long ignored technical quality in setting compensation, as long as the quality, or lack thereof, did not adversely impact short-term economic performance. Some firms have even been careless in screening poor quality lawyers prior to promotion to partner. As a result, many firms find themselves with at least a few quality problems among their partners. To the extent that these are not so strong as to warrant termination, firms are beginning to take quality into account when setting partner compensation. The best lawyers are paid more, all other things being equal. Assessment of quality places a premium on input from clients, department and practice group heads, and other partners.

Intellectual Contributions

Law firms add value for clients by using knowledge and intellectual creativity to solve the clients' problems. In general, firms at the cutting edge of practice earn greater fees and enjoy higher levels of prestige. Partners who contribute to keeping the firm at the cutting edge intellectually should be rewarded for their contributions.

For example, a partner might devise a solution to a particular type of tax problem. That solution has far more value to the client than the ten minutes in the shower it took to create. The firm should bill, and compensate, accordingly. Another partner may devise a deal structure which can then be applied for other clients. Such contributions, while not easy to measure, are vital to the firm's long-term success.

Project Management

Some lawyers, while not rainmakers, can nevertheless manage substantial client projects or multiple client projects and assure their successful completion. Historically, this contribution was often undervalued, unless present in the same lawyers responsible for originating the clients. Because it is vital to the success of the client relationship and to institutionalizing the client base, firms can no longer afford to ignore project management. And, as alternative billing arrangements such as fixed fees become more common, profitable project management will be more crucial. Measurement tools, including write-off analysis, inventory analysis and matter profitability analysis will all play a part in determining who are the strongest project managers.

Leadership

Given the number of firms that have gotten in trouble in recent years due to lack of direction, it has become clear that true leadership in a law firm is both a scarce and valuable commodity. Without partners capable of setting a true direction for the firm and leading others toward it, most firms flounder. The importance of leadership will become more apparent as the legal marketplace becomes ever more competitive. Rewarding those who contribute leadership will help assure continued strength.

Firm and Practice Management

Many firms have long paid lip service to management in setting compensation. However, except for a few individuals, often only the managing partner, the only real effect management has had on compensation has been to serve as a "credit" against the partner's billable hours requirement. The importance of management and practice management at various levels is becoming clearer as firms face ever greater market challenges. Enlightened firms will begin to view management as more than just a necessary evil, and reward partners based on how they perform in management roles. The success or failure of their efforts, rather than just holding the position, will become a crucial factor in setting compensation.

There are, of course, a variety of individual criteria which might be important in setting partner compensation. Firms should look at what an individual partner brings to the table and make decisions accordingly. However, it is clear that enlightened firms, in addition to valuing some of the same criteria long considered important, will begin to expand criteria to consider those which contribute to long-term success. Only in this way can a firm remain competitive.