

Law Firm Partner Compensation

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No issue can be more divisive or cause more controversy in a law firm than compensation. How a firm compensates its partners and employees will be a significant factor in the firm's success. Partner compensation is a subject that causes much debate and animosity in law firms.

When partners describe their concerns as compensation issues, it is very often an indication of other concerns with their firm, such as:

- A feeling that the firm is not being *managed* or administered properly,
- a lack of *communication* with management, or
- *poorly articulated* compensation criteria.

While some lawyers are unhappy with the income they receive as an absolute matter, the vast majority of partners that complain about partner compensation focus on "relative" compensation or procedural issues including:

- The attorney's compensation compared with another attorney in the firm,
- the attorney's compensation compared with their peers in another firm, or
- the application of the firm's partner compensation system.

The first, comparisons within the firm, is the age old compensation problem in all organizations. Because status anxiety is part of the human condition, people react strongly to differences in benefits, including compensation, of the people with whom they work most closely. Therefore, regardless of the compensation system used by the firm, differences, particularly small differences, must be well thought out by whoever is setting compensation.

Second, comparisons with peers, or the *American Lawyer* Journal problem. Prior to the publication of the *American Lawyer*, attorneys from firm to firm really didn't know what their peers were making. Also, even if they did have some anecdotal information, it didn't bother them as much as the publication of the information did. However, once the *American Lawyer* started publishing comparative compensation, everyone, including friends and spouses, had a window into law firm compensation that they could use as a measuring stick to evaluate the financial success, and to some, the success, of law firms and their partners. All of a sudden, firms started focusing on beating the profits per partner of their competitors. Of course, since the Internet, information is more readily available, and as the legal industry matures and consolidates, compensation information would have become more transparent because of mobility in the profession.

Finally, partner compensation system concerns are usually implementation concerns. Almost any compensation system can work if it is perceived to be fairly administered. Different systems work for different firms at various stages of their

development. Most systems work well during good economic times and when the firm is earning more than it did during the year before. Most systems work when the partners trust the decisions makers.

In general, most partner compensation systems are either merit (performance), or lockstep (seniority). There are many different systems that are merit or performance based. The systems are prospective (compensation set in advance), retrospective (compensation set after the year), percentage or points based, with or without a bonus pool, etc.

Lockstep systems are rare today, but the major places which these are still in use are large London firms and some New York firms. Lock-step works best when firm management has an institutional approach and wants to instill that business mentality in the firm's lawyers. It also works best when statistics and information which value individual contributions are not kept or made available to the partners. Its obvious short-coming is that it does not reward the "superstar" lawyer-the attorney with a large book of business and/or exceptional practitioners. In some cases it makes the firm vulnerable to lateral "cherry picking." Therefore, lock-step is only effectively used by firm's that really have no reason to fear lateral departures- firms like Cravath in New York, and Alan & Overy based in London.

Total contribution merit systems are the most popular compensation systems for growing law firms. The theory is that the firm's profits should be distributed based upon the total contribution of the partner. It allows management to focus compensation on the efforts that are most important to the future of the firm.

There are many approaches which firms use to make these decisions-varying from one as simple as a group sitting down, talking about each partner's contributions, to using a formula as a starting point for contribution discussions.

One approach is for the compensation committee, which may be the Management Committee, to evaluate all partners using a set of criteria, and prospectively set each partner's compensation for the next year (see Illustration #1). Also, during the last ten years, firms have begun to retain a "bonus pool" discretionary fund to be determined retrospectively and award unexpected and exceptional contributions. If a firm does use a bonus pool, it is important that different criteria be applied other than those used to set the basic compensation points.

Here are some of the compensation considerations that are generally used:

- Billable Hours
- Production (hours x rate)
- Total Hours Worked*, including hours totals for:
 - Firm Management
 - Practice Management
 - Recruiting

- Bar Association and Community Activities
- Marketing
- Collections
- Realization
- Business Development
- Quality of Legal Work
- Seniority
- Achievement of agreed personal goals

*Firm's that focus on production and collections call these "soft" hours.

ILLUSTRATION #1

A compensation system used by a large firm with 95 partners

<u>Tier</u>	<u>Partner(s)</u>	<u>Compensation</u>
1	1, 2	\$1.2 m
2	3, 4, 5	1.0 m
3	6, 7, 8, 9	875K
4		750K
5		650K
6		550K
7		475K
8		400K
9	85- 89	350K
10	90- 95 (new partners)	300K

- Tiers based on criteria (10-12 tiers for 95 partners)
- Look at budgeted profits and prior year profits – assign points based upon lower total (for example, 90%)
- Meaningful differences between tiers

Most large U.S. firms use a compensation system in which partners are placed in tiers according to some of these criteria. Such a system allows firm management to focus compensation on those partners whose efforts are most important to the future of the firm.

When these systems fail, it is generally because the partners do not understand what is being valued. In some firms compensation decisions are perceived to be arbitrary because the criteria are always changing. Also, very important measures such as business origination are difficult to fairly assess. Because of this, subjective systems

sometimes fail to achieve the perception of fairness, or advance the firms strategic goals.

When a firm does decide to change its compensation system, focusing on the following will help the change be accepted:

1. Compensation should be fair and adequately reward contribution.
2. The compensation system should reward behavior which is in furtherance of firm goals and agreed personal practice goals.
3. A particular system should not be adopted just because it works for another firm.
4. Outside experts can be very helpful. They can be objective, have no personal axe to grind, and can listen to all perspectives. (For example where each partner wants a system that values his or her strengths).
5. Avoid small differences in income.
6. Avoid major income swings from year to year.
7. Explain the new system so all partners understand it.

The best compensation systems reward total effort, motivate partners towards achieving individual practice goals and firm goals, and help build the institution.

Conclusion

Law firm compensation issues are affected by a number of factors, the most important of which are the following:

- The market
- The firm's culture and it's goals
- Total contribution of the individual

Partner compensation is an important strategic issue for law firms. It can have a dramatic impact on whether or not the firm accomplishes its goals.