Compensation Design for Law Firms

EDITED BY HELEN ROCHE

PUBLISHED BY managingpartner IN ASSOCIATION WITH ark GROUP

Compensation Design for Law Firms
is published by Managing Partner in association with Ark Group

UK/EUROPE/ASIA OFFICE
Ark Conferences Ltd
6-14 Underwood Street
London N1 7JQ
United Kingdom
Tel +44 (0)207 566 5792
Fax +44 (0)20 7324 2373
publishing@ark-group.com

NORTH AMERICA OFFICE
Ark Group Inc
4408 N. Rockwood Drive
Suite 150
Peoria IL 61614
United States
Tel +1 309 495 2853
Fax +1 309 495 2858
publishingna@ark-group.com

AUSTRALIA/NZ OFFICE
Ark Group Australia Pty Ltd
Main Level
83 Walker Street
North Sydney NSW 2060
Australia
Tel +61 1300 550 662
Fax +61 1300 550 663
aga@arkgroupasia.com

Online bookshop
www.ark-group.com/bookshop

Commissioning Editor – Legal
Helen Roche
hroche@ark-group.com

Reports Publisher – International
Fiona Tucker
fiona.tucker@ark-group.com

UK/Europe/Asia enquiries
Ken Fitzgerald
ken.fitzgerald@wilmington.co.uk

US enquiries
Daniel Smallwood
dsmallwood@ark-group.com

Australia/NZ enquiries
Steve Oesterreich
aga@arkgroupasia.com

ISBN: 978-1-78358-105-4 (hard copy)
978-1-78358-106-1 (PDF)

ARK2673

Compensation systems: Integrating partner incentives with firm goals

By Arthur G. Greene, principal with Boyer Greene LLC

PARTNER COMPENSATION systems are designed to fairly allocate the profits among the partners based on their individual contributions to the success of the firm. For many successful firms, the compensation process has become more than that. Compensation systems have become powerful management tools that reward actions and behaviors the firm wants to encourage. The challenge is to balance individual partner incentives while successfully promoting the firm's strategic goals in a process that is credible and fair.

More law firms are recognizing that partner compensation and the firm's strategic plan are directly related. They should not be considered separate processes. Integrating partner incentives with the goals of the firm's strategic plan through the use of partner annual plans has become an essential aspect of good management.

Partner annual plans are written documents describing any changes in the partners' intended commitment to the firm in the following year. Annual plans can be developed by each partner in discussion with, and approval of, firm management. They represent an excellent method for receiving commitments from partners while at the same time providing each of them with a clear message as to the firm's expectations for their performance during the coming year. When tied to the compensation process, they also provide a clear basis for evaluating whether or not the partner has met the commitments they have made to the firm. A review of a partner's annual plan at the end of the year will disclose clear markers which can support compensation decisions.

The management approach of integrating individual incentives may seem simple enough, but encouraging desired actions and then measuring the contribution of each partner requires a credible system and a fair process. The use of annual plans will make any compensation system more open, fair, and credible.

Achieving an integrated approach

The emerging trend among law firm leaders is to promote the firm's strategic plan by integrating it with incentives in the partner compensation system. Depending on the size of the firm, this process can be managed by either the managing partner or the practice group chairs. The critical components involve integrating the firm's strategic plan, a partner annual plan process, and the partner compensation system.

Strategic plan

A strategic plan will set forth the firm's vision for the future with appropriate goals and objectives, along with an intended timeline. The exercise of creating the strategic plan will require all partners coming together in pursuit of a common mission. The strategic plan then allows leadership to make decisions and allocate resources designed to achieve the goals of the plan, rather than make decisions based on a day-to-day perspective. By integrating the partner annual plans into the process, management can be assured that the partners are coordinated in their effort to achieve the stated goals. The next step, of course, is to reward partners based on their performance in achieving the expectations set out in their annual plans.

Once a strategic plan is in place, the next process is to identify the individual actions critical to achieving the goals of the plan. Perhaps they include:

- Originating new clients;
- Creating new practice areas;
- Expanding the firm's geographical reach;
- Developing new marketing approaches;
- Performing work profitability;
- Delegating work to others;
- Leveraging associates and paralegals;
- Training and mentoring associates;
- Changing aspects of management; and/or
- Providing desired leadership.

Each partner will be positioned differently and each of their specific roles in achieving the firm goals will be different. Management needs to identify the actions or behaviors needed by each partner on an individual basis, so that all the necessary parts of the firm's strategic plan will be covered by one or more of the current partners.

Partner annual plans

Partner annual plans provide management with an ability to work with each partner in order to coordinate individual efforts in the context of the firm's strategic plan. The annual plan is an excellent means of communicating what is required from the firm's perspective and the role each partner needs to play in order to achieve the firm goals.

There are a number of different formats available and many firms tailor their own form to fit the firm's individual circumstances. The following topics would likely be included and each partner would commit to their own individual effort to:

- Enhance their skills;
- Expand their practice;
- Improve their productivity;
- Assist others in improving their practice;
- Advance the goals and objectives of the firm;
- Help with management; and
- Participate in civic and professional matters.

A financial aspect is also critical to each annual plan. Expectations as to billable hours, revenue produced from the files managed, the realization rate for the files managed, and the dollar value of originations would be included. The first draft of the annual plan should be prepared by the individual partners, and then the annual plans would be finalized in a session with the managing partner or practice group leader, during which the needs of the firm would be considered and negotiated into the plan.

Compensation systems

Partner compensation is often discussed in terms of four basic methods. However, the number of variations and/or combinations exceed anyone's ability to categorize or count them. While some law firms start out with the traditional partnership concept of sharing profits equally, this method does not stand the test of time. Equal sharing of profits may be seen in start-up firms, but not in established firms that have grown over time. Other firms may have vestiges of the lock-step system, now out of favor (at least in the United States), where partners move up the compensation ladder in predetermined steps, based on seniority. While many of the larger US firms may have operated with such a system 30 or 40 years ago, nearly all have evolved away from that seniority-based system. Today, most firms have a formula-based system, a subjective-based system, or some combination of the two.

Formula-based systems

A formula-based system, which emphasizes each partner's contribution to revenue production, is more common in small firms. Credit is usually given for originations, managing the client, and performing the work. Formula-based firms tend to have weak management and give limited attention to contributions other than producing revenue. While formula systems can work successfully for a period of time under certain circumstances, they do not promote long range success or the growth of the firm as an institution. As law firms mature, they tend to move away from formula-based systems in favor of a subjective-based system.

Subjective-based systems

A subjective-based compensation system involves prospectively setting the compensation percentage (or points) based on an evaluation of each partner's overall contribution to the firm. The factors to be considered in the process are identified and agreed to in advance. While revenue production numbers are important, they are evaluated subjectively without math being part of the process. In addition to contributions to the production of revenue, other factors that are typically considered include: leadership abilities, management, teamwork, associate training, and community involvement. Advocates of subjective-based systems point out that they promote the success of the firm as a whole, rather than individual successes.

Combination systems

Many law firms end up with combination systems. In some cases these are arrived at by accident, while in other circumstances they represent a thoughtful approach incorporating both subjective factors and objective formula-based incentives. Examples could be endless, but they would include:

- All partners receiving the same base compensation (perhaps representing 60 per cent of the overall compensation), then at year-end a formula is applied to allocate the balance of the profits;
- The partner base compensation is set based on their respective contributions to the firm, measured subjectively and paid prospectively, and then at year-end any bonus is paid, based on a retrospective formula; or
- The base compensation is established on a formula, then at year-end a predetermined percentage of the profits is allocated subjectively to those partners who made significant contributions to the success of the firm that are not effectively measured by the formula.

For the purposes of this discussion, the two significant points are:

i Integrating individual incentives and the firm's strategic plan requires that the firm has a subjective system, or a combination system with a substantial subjective component; and ii The most favored systems for successful and enduring mid-sized and larger firms tend to be subjectively based.

The compensation process should include a review of each partner's performance in achieving the expectations set forth on the prior year's annual plan. Incorporating this into a firm's existing compensation system may take some adjustment to the process. Although the annual plan aspect of the discussion may be subjective in nature, the message is clear: partners are rewarded for their overall contribution to the firm's goals based on expectations set forth in their annual plan.

A point to keep in mind

Protecting the law firm as an institution is the cardinal rule. Simply put, the law firm comes first and decisions need to be made based on what is best for the firm, as opposed to what is best for any individual. The integration of the firm's strategic plan with its partner compensation system reinforces this important concept.

It takes a mix of different talents and skills to serve clients and operate a successful firm. These differing skills may vary in importance and will need to be rewarded based on their relative value to the firm. Be forewarned, those firms with compensation systems focusing predominately on one skill, to the exclusion of others, are not likely to attain the success they might otherwise expect. The annual plans provide an important tool for identifying and managing different contributions.

Accept the fact that the allocation of profits among the partners will cause tension. This tension can be healthy if the partners understand the workings of the compensation system and know how their actions and behaviors will affect their compensation. Obviously, good communication and candid discussions are necessary to developing the level of trust which is critical to managing a successful partner compensation system.

'A rising tide raises all of the boats'. In the law firm context, a rising tide means that if the firm does well, each individual will do well. The reverse is not true. Most firms want a compensation system that will incentivize actions and behaviors that will improve the chances of the firm, as a whole, doing well.

Finally, do not overlook the importance of a smooth process for succession. The compensation systems should be designed to reward senior partners for beginning to transfer clients, otherwise there will be a tendency to retain exclusive client control. This is particularly true if one of the firm's unintended consequences of its compensation system incentivizes the senior partner to retain control of the clients in order to support their continuing compensation.

When change is necessary

Many firms have compensation systems that provide the wrong incentives which have a detrimental effect on the firm's effort to promote stability and maximize success. Tension over the compensation system can rise to the level of disrupting the firm's ability to succeed. An unhealthy compensation system tends to promote internal competition among the partners – whose energies should be directed externally. Unfortunately, many partners working under a dysfunctional system become resigned to the fact that the system they know may be better than the risks associated with change.

Whatever the system, it is likely to have been developed by the founder and reflect the early culture of the firm. What may have been an appropriate compensation system in 1980, or in 1950, most likely is not the best system for the firm today. Compensation systems should be reviewed every five years due to changes, both in the marketplace and in the makeup of the firm.

A partner compensation system needs to be re-evaluated if it:

- Is not well understood by the partners;
- Is overly complex;
- Is not considered credible and fair;
- Does not involve open and candid discussions;
- Fails to reward desired actions or behaviors;
- Rewards unwanted behaviors;
- Allows partners to 'game' the system;
- Does not advance the firm's strategic plan;
- Puts the success of the individual ahead of the success of the firm;
- Does not promote orderly transitions;
- Creates an unhealthy tension among the partners;
- Causes excessive internal competition;
- Results in disruption; and/or
- Has not been re-evaluated in over five years.

The best process for re-evaluating or changing a compensation system involves open and candid discussions, orchestrated by a committee with diverse interests represented. The best results often come from building from the bottom up, rather than being imposed from the top down. Inclusion is key.

The required ingredients to support change include:

1. Identifying the goals and objectives of the firm in the strategic planning process;
2. Understanding the partner actions and behaviors required to achieve the goals;
3. Aligning the financial reports to reflect the data relevant to managing those goals;
4. Adjusting the partner compensation system to reward contributions to those goals; and
5. Developing partner annual plans that articulate specific individual contributions.

Using the partner compensation system as a management tool does not make partner compensation more complicated or more difficult. To the contrary, if properly structured and implemented, it will improve the partner compensation process, reduce tensions in the partner ranks, incentivize partners, and promote the strategic goals of the firm in an open, fair, and credible process.