Linking Profitability to Law Firm Partner Compensation: Walking the Line Between Acceleration and Self Destruction

By Joseph B. Altonji on July 6, 2020

The current COVID crisis will have the effect of accelerating a trend that has been on the horizon for some time – moving the legal industry in the direction of creating explicit linkages between partner compensation and practice profitability. As I noted in a recent article, *"Rethinking Partner Compensation Systems in Light of COVID-19?,"* incorporating profitability into law firm partner compensation systems "will need to be handled carefully, but deliberately. It is not too early for leaders to begin thinking about what this will mean for your firm." In this article, we will begin to explore what that might mean for the industry, and how we can avoid falling into some of the fairly obvious danger zones associated with this endeavor.

"Profitability" has been a tortured concept in the legal industry for some time, but in recent years profitability management has become an increasing focus of firm leadership, and most firms have begun developing skills, techniques and training protocols around what it means to have a "profitable" practice in a firm. Nonetheless, most firms have a long way to go in terms of understanding profitability, much less managing it. Explicitly linking it to partner compensation remains, for most, a bridge too far to *openly* consider. Implicit linkages are a different matter. Over the course of many conversations with clients in the year or so prior to COVID, profitability was a frequent topic of conversation but explicitly using profitability analytics in compensation setting remained on the distant horizon for most. Whenever you ask the question of "Do you formally link the profitability of your partners' practices to their compensation levels?" the answer is almost always negative. But there are few Managing Partners who do not understand, at least on an intuitive level, the relative profitability of their partner's practices, and when pushed will admit to factoring that understanding into their compensation thinking.

COVID will accelerate the focus on practice profitability, and by its extension its incorporation into partner compensation systems. At its most basic level, not all $1M (or $10M) books of business are created equal. Some practices are more profitable than others, and the sources of these differential results come both from external factors (e.g. relative market value, true costs of production, etc.) and from internal factors, mainly those within the control of the individual partner (e.g. practice management discipline, financial hygiene, pricing skills, client relationship management, etc.). The bottom line is, some practices produce more profit for the firm than others, both in an absolute sense and in a "margin" sense, *and this will always be true*. This has always been one of the dirty little secrets of law firms, and maintaining the illusion that partners with comparable "top line" numbers have, all other things being equal, comparable *economic* worth to the firm has been central to maintaining the "culture" of most firms. Most compensation systems reinforce that illusion, but the fact is that profitability varies materially based on a wide variety of factors, and measurement of that profitability can sometimes complicate the conversation. (We are not, in this article, going to go into the challenges of actually calculating profitability.)

Historically, firms have been reluctant to formally incorporate profitability measurement into their partner compensation systems for a variety of reasons, including:

- Lack of technical and/or accounting wherewithal to measure profitability, leading to an absence of useful data.
- Lack of internal agreement on a definition of "profitability" or on the approach to its calculation, including a lack of

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agreement on cost and revenue allocation approaches.

- Strong (and justified) concerns around the cultural impacts of sharing profitability data and potential for dramatic upheaval associated with highlighting profitability differentials.
- A fundamental misunderstanding in the industry about what “profit” even means, coupled with the illusion that firms run profit margins typically in the 30-60% range. (This is only possible because traditional law firm accounting practices consider the contributed professional efforts of their equity partners as a “cost-free” resource. Note that, in this point, we are discussing a conceptual challenge rather than the lack of technical agreement identified in the second bullet above.)
- Lack of agreement around the appropriate use of profitability information in allocating compensation, or consideration of the relevant competing values for use of firm “profits.”

The first two reasons noted above are being addressed at many firms today and we anticipate that, particularly in the Post-COVID environment, most firms that have not stepped up on these topics will be forced to catch up as rapidly as possible. Our work with clients on these topics suggests that within a few years management of most firms will have developed at least a basic understanding of the profitability of their practices and key clients. Partner education lags even further behind, however, and formally incorporating profitability data in the firm’s compensation system is likely a recipe for disaster in partner relationships. This will force most firms to play catch-up on the educational front as well.

The three remaining challenges identified above create somewhat stronger barriers to successfully incorporating profitability data into partner compensation and deserve more careful thought. Ultimately, firms will need to engage in some very difficult conversations to find a balance between *using* and *misusing* profitability data. However, we can offer some initial thoughts to get those conversations started.

Transparency of Profitability Data

Demands for transparency around law firm performance data have been increasing over the past decade and are likely to continue to increase as today’s younger lawyers move up the ranks of partnership and begin to take a more prominent role in firm affairs. Historically, the concept of sharing partner-level profitability data, or even practice level profitability data, has been a source of immense concern to firm leadership, who fear several (admittedly likely) outcomes from such sharing, including the potential for increased friction in the partnership over relative contributions and pay, and the potential for loss of valuable lawyers and/or practices who are either 1) portrayed as unprofitable or less profitable than other lawyers or 2) believe they can make more if they move to another firm where they don’t have to “subsidize” their colleagues. Related to this is the potential for serious cultural damage which might arise when some partners begin to demand that they be paid the “profits they’ve created” while often not even understanding what the data means, how the business of law works, or the competing needs for investment to assure the future of a healthy law firm. Few firm leaders relish the idea of encouraging a push in the direction of an “eat what you kill” money-oriented culture where the allocation of money takes precedent over the best interests of the firm and, by extension, the creation of profits.

Much of this challenge can be addressed by strong education programs coupled with a more sophisticated shared understanding of the firm’s strategy and the concepts of profitability and investment. In addition, we would advise most firms not to publish profitability data as it is currently generally produced, and certainly not as it relates to individual partners. Rather, until more sophisticated thinking around profitability takes hold, it would be better to focus profitability analytics around practice areas (or better yet, work types) as well as clients. Individual partner analytics, to the extent they are needed, are better focused on coaching the individual partner on how to improve their profitability, rather than on formulaic allocations of compensation. However, when a clear case of a partner whose profitability is seriously lagging

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expectations or greatly exceeding them exists, that data might form an appropriate input to the compensation process without being used to create public discussions around individual performance.

General Lack of Understanding of the Meaning of "Profit"

We and others have often commented that the general industry definition of "profit", particularly in the US, bears little relationship to the economic definition of profit. Defining all money available to the equity partners as "profit" belies the facts that a partner's time has a cost and no one works for free. Before factoring profitability formally into compensation, the industry and individual firms would help themselves by really thinking through what "profit" means and separating the fair market compensation component of partner pay from the allocation of restated firm profits. By extension, most profitability analytics approaches would need to be revised to accommodate this analysis.

By revising compensation systems to first compensate their partners based on the reasonable market value of their contributed work (including compensation based on "sales" and leadership and other roles in addition to client work) and subsequently allocating the residual profit of the enterprise (both to the partners based on an agreed approach to how true profit should be shared and to investment priorities) the firm can separate the questions of how much a partner's short term contributions are worth from the issue of who should benefit from the long term creation of a profitable enterprise. The latter question might be addressed through a variety of mechanisms including 1) capital investment 2) demonstrated contributions to the creation of brand/firm/practice value and 3) leadership contributions to growing the firm's profitability, size, and other values. In theory, this separation can also create opportunities for creating linkages between a partner's contribution to value creation during their active practice years and a post-retirement benefit value.

Lack of Agreement Around Use of Profits or Their Role in Compensation

It hardly needs to be said but there is little agreement in the industry on how "profit" should be used in a firm (other than to distribute it to partners). This would not disappear but might get easier to manage if the industry reached a better understanding of what profit actually means, as set out in the prior section. However, assuming we progressed toward a true economic understanding of profit (i.e. after paying the partners a reasonable market level of compensation for what they actually do), it becomes a lot easier to think about what should be done with that profit, as any other business might. Generically, there are only a few things that can be done with law firm economic profits that might enter the conversation:

- Allocate them to the owners of the firm based on their respective capital investments in the firm.
- Allocate them among the owners (and potentially others) who have contributed intellectual capital or sweat equity in a manner that has created long term value beyond what they have been paid in compensation. (Analogous to a stock grant or phantom stock rights in a corporation.)
- Use the profits to invest in new ventures and areas of new opportunity for the firm. It should be noted that in many firms some of the most "profitable" practices are the older, stable, and non-growing practices whose time may be past but where there is still the ability to generate material cash in excess of true costs. These "cash cows" should be expected to generate investment capital for the "rising star" practices of the firm. (Refer to Boston Consulting Group's famous Growth-Share Matrix.)
- Create "retained earnings" (irrespective of firm legal structure or accounting method) to increase firm flexibility and resilience. In a partnership, this use of profits would necessitate an allocation to the capital accounts of specific partners, of course.
- Use the profits to purchase stakes in new businesses or fund costs of growth through acquisition or combination.

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While there might be other generic uses for firm profits, this limited list does help clarify the leadership and partnership conversation which should take place as firms begin to consider incorporating profitability into partner compensation decisions. It also forces the debate to focus on the strategic opportunities the firm has and the necessity of recognizing a tradeoff between investment and compensating partners. By clearly agreeing that partners have been properly compensated for working *before* we begin a discussion around allocating profits, the firm is put in a position to both discuss profitability without devolving into divisive and unproductive conversations *and* to force a discussion around strategy and strategic investment.

These conversations are just beginning, but there is little doubt in our minds that a focus on profitability and by extension, the incorporation of profitability analysis into partner compensation systems is coming. We hope that when that time comes for your firm you will be well-positioned to have the discussion in a healthy and productive way.

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