Rethinking Partner Compensation Systems in Light of COVID-19?

By Joseph B. Altonji on May 12, 2020

As we plan for reemergence from the current business restrictions necessitated by COVID-19, it might seem a bit early to think about what changes to compensation allocations and systems might be needed in light of the current crisis, but those questions will be front and center sooner than most would like. If your firm experiences a material decline in current year earnings as a result of the crisis (some will see a material hit, some will likely see a modest decline, and others could be flat or even up at year end) these questions will be even more pressing. It's not too early to start thinking about two key questions:

- How will we handle Partner compensation this year in light of a totally unprecedented set of (hopefully) limited-duration conditions, and
- What long term changes will be needed in light of changed operational, market or strategic considerations coming out of the Pandemic?

These questions should be considered separately but will be interrelated on many levels.

What will need to be different this year?

In the short-term, particularly for those firms that find themselves with materially less money to go around than they had planned, handling the allocation of profits to Partners this year may become in part a question of philosophy and style. To what extent does the firm stick to a philosophy of "we're all in this together," supported by 2-3 year "look-backs" in performance data, as opposed to "we need to reward our most valuable people right now?" In practice, most firms will have an element of both approaches in their thinking. However, the pandemic itself will likely have the effect of shifting actual economic contributions for the year materially away from the anticipated economic contributions which drove most firms' level and point setting at the beginning of 2020, and these shifts may or may not continue into 2021 and beyond. This will lead to stresses on already stressed bonus pools and cause serious conversations around next year's prospective allocations.

The changes in individual economic contributions away from expectations will be driven by factors including:

- Material and very rapid changes in workloads, which may continue for some months. Some lawyers today are busier than at any point in their careers, while others who are normally in high demand, often at higher rates, are seeing a material drop-off in their workloads or are expecting drop-offs in coming months.
- Business generation patterns will also shift based toward in-demand practices compared with expectations. Some partners may see their "best year ever," at least on a production level, while others are way off from their normal track.
- Partners focused on specific highly stressed industries may also see material shifts in their business bases and experience even greater impacts on their cash collections. Those servicing airlines, cruise lines, hotels and hospitality, oil & gas and various other industries will see shifting demand patterns, and even greater than normal pressures on fees based on client liquidity and their ability to pay, especially this year. Receivables may be much higher (and riskier) at year end for some partners than for others.

In addition, there will be short-term compensation considerations based on differential ability to “rise to the occasion” and be a productive contributor under our current highly stressed conditions. Who figures out how to stay connected to clients and deliver what they need now, keep them connected to the firm and improve the firm’s relationships, regardless of “credit”? Which lawyers showed the capability and initiative to contribute to the firm’s market position and visibility? Who is producing or supporting the production of advisories and client webinars? Who stepped up in positive ways to support and build morale, improve team connectivity or build training/retraining programs for younger lawyers who might have had time on their hands? What Practice Group Leaders adapted well to the virtual environment, rallying their groups to succeed or at least do better in the current conditions than others? Who did not?

All of these factors might play a role in allocations of this year’s income. In the short-term, preliminary conversations of firm leadership around how these topics will be handled this year, along with taking steps to document the initiatives of those who really stepped up in ways not reflected in normal economic stats, would be valuable. Communication of leadership’s thinking around these issues also should take place sooner rather than later.

What about the long(er) term?

Longer term, the COVID-19 Pandemic is likely to both accelerate trends we’ve already seen in law firm Partner compensation thinking and introduce new variables, metrics and potentially new philosophical considerations for compensation design. In addition, as we’ve discussed in our “Legal Industry in a “Post-COVID’ World” series (see especially Part 4), we believe most firms will be facing a strategic pivot point of some significance. As always, to the extent that the firm undertakes a strategic pivot, it is absolutely appropriate (or imperative) to revisit the firm’s compensation approach to ensure alignment with the new goals and incentivize the appropriate behaviors.

Irrespective of changes based on strategic adjustments, most firms should be taking near-term steps to adjust their Partner compensation approach and the contributions they evaluate. Among the factors which warrant increased scrutiny are:

- **Practice and client profitability management**. Some firms have already moved toward building more sophisticated supporting analyses and understanding of profitability around practices and clients while others are just placing their toes in these waters. These efforts will be accelerated as we come out of the current crisis, and the necessary extension of these analytics into more formal inclusion in compensation setting will follow at a much more rapid pace than it would have absent the current crisis. How firms begin to incorporate profitability analytics into their compensation system will be a subject of much debate and even more cultural risk. It 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.
- **Individual practice management.** Team and matter management skills will be taxed, and new skills will be needed. Managing virtual teams, and potentially multi-firm teams, where clients demand teams comprised of lawyers from different firms brought together to address to address more challenging problems, will be increasingly needed. Lawyers who adapt well to these conditions will be more valuable to clients in future years, and a firm’s ability to play in the trusted advisor space for important clients will depend critically on building these skills.
- **Practice Leader performance**. As significant elements of virtual practices are increasingly embedded in the industry, the importance of Practice Leaders doing their job well will be far more important than ever before. Historically, most firms had widely divergent outcomes from different Practice Leaders, and these leaders were not always selected for their skills at leadership and management but because of their positions of influence and/or economic clout. In a heavily virtual world, firms will not have the luxury of poor practice management if they want to assure high quality client service and, just as importantly, firm cultural connectivity and cohesion.

- **Institutionalized financial management improvements**. One positive outcome of the crisis has been the final shift toward behaviors firm leaders have been trying to embed for decades, such as online daily time entry by all lawyers, on-time turnaround of prebills and handling of billing by the accounting department, and better cash management and management of WIP and AR. No firm wants to lose these gains, and the use of compensation as a disincentive to any backsliding will meet materially increased cultural acceptance.
- **Transparency will increase.** Demographic trends have been pushing firms toward increasing transparency in the normal course of business. This will be seriously accelerated as the profitability of practices shift, individual partners find their practices materially diminished, and others find theirs under suddenly increased pricing pressures. In addition, to the extent that new virtual approaches to practice result in younger partners accelerating their rise up the ranks of leadership (not unlikely as they tend to be more adaptable to new conditions than older lawyers whose success has been embedded in historic business models and approaches that have long served them well) the resulting internal power shift in firms will accelerate transparency demands. Firms better be ready for this or they risk significant cultural challenges. (Can your firm's "black box" stand up in the light of day?)

These and other factors will be even more significantly enhanced to the extent that the crisis and its aftermath results in specific strategic pivots by various firms. For example,

- Moving material parts of the practice to different pricing models, or service delivery models, will increase the emphasis on profitability management and speed the use of profitability in compensation systems.
- Changes in operational platforms in the direction of reduced space commitments, virtual support capabilities, and more flexible, on-demand support will increase pressure to treat partners wedded to "old style" overhead structures differently than those willing and able to move toward reduced cost approaches.
- Any strategic shift in targeted client bases, market position and talent acquisition strategies will necessarily force a reconsideration of what is most valued by the firm, and where it should invest (i.e. be willing to pay) for people to develop or re-develop the firm's practices.

There will be more changes that will emerge over the next several months. Our goal here is to get leaders thinking – early – about whether compensation systems might need to be adjusted. If you started the year thinking maybe this year was the year you should think about looking at compensation, then the pandemic makes this a certainty. Yes, you should, and it has short- and long-term implications. If your compensation system was working well and is not an issue at the moment, think about it again. At a minimum, you will need to make adjustments in the short-term, and critical trends will put longer term stress on the system. At the very least, have the discussion and consider whether to begin making adjustments before things become a problem. Compensation is always under the microscope at most firms, and the current crisis has just made this a critical area of focus for the next 6-12 months.