Shifting the Conversation on Associate Compensation: From "What Can We Afford?" to "Where Should We Be?"

By Joseph B. Altonji on February 10, 2022

There may be no single *economic* challenge facing law firms today bigger than the current war for talent. Driven by transactional practices, the acceleration of base compensation and bonuses started last year and continuing through the latest 2022 jumps has affected all commercial law practices and is hitting mid-sized firms hard. Firms everywhere are losing young transactional lawyers to much bigger firms that offer six-figure increases in compensation and material signing bonuses. Making matters worse, some larger firms are taking advantage of the Covid-inspired transition to remote work to move outside their own geographic footprint, targeting lawyers anywhere they can find them.

Although commentators are beginning to ask, "What happens when the music stops?," until it does, firm leaders are reacting to a different question: "What can we afford to pay these lawyers?" Most firms have taken a first pass, raising salaries across the ranks. While recognizing that they can't match the market leaders, they hope to come close enough so the young lawyers will evaluate the options they face and decide to stay. *After the fact*, firms start to think about what adjustments (to rates, hours, etc.) they can make to at least not fall backward. Most of the time, costs increase in advance of performance changes.

But what if we flipped the question? Rather than asking "What can we afford?," what if firms focused on "Where *should* we be on compensation?" given everything, including:

- The *actual market value* of the practices associates belong to, and the overall firm position.
- The *actual* clients your firm serves.
- The real *alternative market* for the specific associates your firm has and needs.
- Geography, and the competition in your market.
- The associate's *actual* work commitment.
- The firm's culture, environment, and commitment to future opportunities.
- The firm's cost structure, economic performance, and matter management approach.

Talent wars paint with a wide brush. Market leaders announce salary increases for all associates – not just the ones they need most. This minimizes internal cultural challenges but drives up costs across the board, driving up rates and inevitably leading to client push-back. It also has the subtle but important effect of weakening or removing a market incentive for young lawyers to help "clear" the market by choosing among practices at least in part by how much they might earn over time. (Yes, eventually differential practice value produces differential compensation outcomes, but within any given firm those differentials tend not to kick in fully until partnership.)

If we flip the question, market leaders will still periodically respond to extreme demand for their services by raising lawyer pay. The clients will continue to pay those firms what it takes to keep those lawyers working on their matters. But firms trying to figure out what to do in response can take a different approach. *First*, evaluate where you *should be* given the nature of your business and your market position. *Then*, figure out how to manage the economic value of that position.

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Deciding where you should be takes more than sticking your thumb in the wind. The benchmark is the market leaders, but your firm should assess the value package you offer associates and set a position relative to the market top that can be sold to the *relevant* market (the associates *you* need). You are looking for the price point where a young lawyer can look at your compensation, and her alternative compensation and say, “when I consider everything that matters, this opportunity is at least as good as the market leader’s offer.” At that point, you can expect to win most of the talent that values the intangible part of the offer more than the monetary part and lose most of those who are just going for the money. Once you have done that, you can focus on improving and clarifying your non-monetary value. Going forward you are less likely to lose people and will win more laterals.

After you get your associate compensation “right,” focus on optimizing your practices to assure you get the best return for your investment. If we should be paying $175K for a first-year, what does that mean we should do to assure our Trust & Estates practice can generate an optimal return? Change our rates? Move to fixed pricing? Add technology? The goal of the firm should not be to homogenize practice economics, or to somehow match the economic performance of others, but to assure you can provide a competitive income to your people *given* the practices, client mix, and market position you occupy. Then, if appropriate, you can work on changing those factors.

One of the critical responses middle-market firms will ultimately need to make as part of this effort is to get far more serious about pricing management. To illustrate (in a bare-bones manner), let’s consider a practice that has been under enormous pressure over the last several years, helping fuel the current talent wars – Private Equity. In PE, a few well-known law firms dominate the “upper end” of the market, but many excellent mid-size firms have strong “middle market” PE practices. From a talent perspective, the capabilities, brainpower, and skills of both may be similar, but it’s likely that as hard as the mid-size firms work, the big-name firm lawyers work harder. Let’s say 50% harder to make the math easy (e.g., 1800 hours vs. 2700). As an exercise, you might argue that your total compensation package should be roughly 2/3rd's of the big-name firms’ since your lawyers are expected to work 2/3rd's the hours. However, given the need for the same scarce talent, you might peg your target compensation package at about 70% of what that same associate can earn by jumping, and hope that is sufficient to retain key talent. But let’s dig deeper and look at pricing. While partially geographical, a mid-market firm is likely to charge somewhere near $300 an hour for a 3rd or 4th year PE associate, while the big-name firm may charge $600 or more for similar work. The firm is looking at a fee generation gap that is much greater than the 50% hours gap noted above. It’s more like 3X the revenue. The greater the spread in rates, the greater the disparity.

Although there are other factors to manage, the *only* way the mid-size firm can keep up with the math is to focus on pricing. We believe that most high-quality middle-market corporate firms are timid on pricing and that focusing on this in a systematic manner can yield significant benefits (we’ve seen them in our work.) Yes, there is a market issue. Smaller deals might not support the same pricing as bigger deals, but we don’t believe this justifies the market gaps we see. More challenging are the internal structural dynamics that arise from digging in deeply and focusing on how much the work itself is worth. What would happen if some associate 3rd-year rates were 2X those in other practices, while those lawyers are also billing more hours? Do we need to rethink the *structure* of the associate compensation system, not just the levels? How does this affect partners? What about internal management dynamics? Are we concerned about creating cultural divides? All are relevant questions, but we believe facing them directly rather than ignoring them in search of internal cultural harmony is a better approach. Failure to do so may lead some to vote with their feet. You gain cultural peace by losing the higher-value parts of your practice.

Managing your way through the talent wars should be a deliberate exercise based on a real understanding both of what your firm’s total employment package looks like and your market position. Playing the game by asking “what you can afford” will likely lead to losing more talent than you gain. Once you have figured out what you should do in the short-run

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(next two months at most!), we urge you to step back and take a hard look at your overall approach to talent management and compensation, and how those systems plug into the firm's overall strategy and profitability. If you are trying to decide where to start, we would be happy to share our thoughts!

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