Time to Change the Partner Compensation System?

By Michael D. Short on May 14, 2013

I was recently discussing some preliminary findings from our ***Partner Compensation System Survey**** with a Managing Partner – issues such as how many firms use each type of system, how long these firms have used the same system, how specific efforts are "weighted" in relation to each other, and who makes the decisions. Some of our findings are not what I expected and I was pointing out the variances between our anticipated results and the realities of many Partner Compensation Systems.

He stopped me mid-sentence and asked, "Are you saying that all firms that don't have these characteristics (that we were discussing) should change their systems?" The slight grin with which he delivered the question indicated to me that he knew the pending response, which was "no"…but not for reasons tied directly to the survey.

My summarized response went something like this – Changing any Partner Compensation System is like handling dynamite. If you know what you're doing and why, everything will go well. If you don't, you could accidentally create some major damage. It is a process fraught with unintended consequences. That said, much has changed since the recession and we see many compensation systems that are grossly out of touch with the new business of law. For this reason, we think it is prudent to revisit them periodically and with an open perspective to ensure that they are not quietly creating long term challenges – even if everything appears to be working well.

Any or all of the following issues could be blind spots in a current Partner Compensation System:

1) Succession planning – The "graying" of many partnerships is a ticking time bomb, with respect to both a) the talent and skills within the partnership, and b) retaining the clients of the Senior Partners. Many compensation systems have no provisions for transitioning a client base, and a successful outcome is often based on the individual Partner's willingness to "do the right thing". While a few will, most cannot foresee retiring any time soon and will hang on to their client relationships to maintain their status in the firm, and their basis for compensation. While the individual Partner benefits, the firm and its client relationships are put at increasing risk as each year passes.

2) Practice profitability – Prior to the recession, there was a fairly strong relationship between the growth rates of both revenue and profits. This was the result of a very stable business model where the only changing variable was billing rates. Today, the relationship between revenue and profits is far less predictable as fee resistance from clients increases and realization rates decline commensurately. In other words, the generation of revenue – which is the primary area of focus for many firms' compensation systems, may not be the best metric for the generation of profits, which is the account from which Partners are paid.

Consider two Partners in the same firm. Each generates the same amount of revenue and the two are paid equally. One generates the revenue via the involvement of a service Partner, an Associate, and a Paralegal. The other generates the revenue via the involvement of two service Partners, two Associates, and two Paralegals. (This is a real scenario that we saw recently.) Should they be paid the same? In some firms, they are.

The second Partner referenced in this example provides commoditized services. If this Partner stays focused on an old, rate-focused service delivery model then the firm and the Partner have limited upside. If the Partner focuses on optimizing the profitability of the work – which is the proper approach – then he/she will suffer – unfairly – under a revenue-based compensation system. Negative consequences equal no action…even if it is in the best interests of the firm.

Important note – involving profitability data in the compensation process is another decision fraught with challenges. That will be a topic for another day.

3) Common/shared work ethic – Each partnership has some range of contributions realized from all Partners. Some contribute at a higher level than others and most compensation systems align the dollars paid with the contributions received, thus making the process "fair". There are, however, limits to the range of contributions that most healthy partnerships can withstand, particularly when someone falls below minimum expectations.

Consider a firm where the average Partner bills 1,700 hours, the top producer billed 1,900 hours and the lowest producer billed 1,500 hours. This is a relatively healthy situation…particularly if the lower billers are investing their idle time in more business development efforts. Contrast this with a firm where the average Partner bills 1,700 hours, the top producer billed 2,100 hours and the lowest producer billed 1,300 hours. A top to bottom variance of 400 hours is much more tolerable for the top producers than a range of 800. The larger the variance, the higher the odds that the top producers leave because a) they feel as if they are subsidizing those who produce less, and/or b) if the lesser producers produced more (an easily achieved feat from the perspective of a top producer) then everyone would make more money. There is a point beyond which different levels of contribution cannot be handled solely via compensation.

Work ethic extends to investment (i.e., non-billable) time. Consider two Partners who both bill 1,700 hours and have the same cash return on that time. One of these Partners spends an additional 700 investment hours working hard to develop business, while the other Partner goes home when the billable work is done. Should these two Partners be paid the same amount? In some firms, they are.

Our survey results tell us what firms are doing. Some would call this "best practices", which is incorrect, old-school thinking. We call it valuable information for a firm to determine if changes are needed and which combination of changes may make the most sense…after, of course, an evaluation of unintended consequences.

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* To date we have over 90 participating law firms in our confidential survey. Detailed results will be made available only to participating law firms. While we are working on our reports and analyses right now, you may still be able to submit your data. Please email me at mshort@lawvisiongroup.com to discuss your participation at this point in time.