Compensation (Re)Design for Law Firms

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Chapter 2:
Trends in partner compensation

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The economic downturn that started in 2008 had a serious impact on most professional services firms. Prior to the Great Recession times were good, very good indeed, for most accounting and law firms. Profitability increased year-by-year and the economy kept professional firms in the money. Under those circumstances there was little need to discuss, let alone worry about, partner compensation. As the saying goes, "Cash is king".

Times have clearly changed. Today the central subject in most professional services firms is what to do about partner compensation, and how partners should be rewarded. Despite all the talk, no one has yet developed the perfect compensation system and it's unlikely that anyone ever will. That, however, does not mean that professional services firms aren't looking to develop better ways to determine partner compensation than the traditional methods of billable time and origination being used today.

What, really, is compensation?

Today, many accounting firms are beginning to look at compensation differently. Compensation was frequently related to draws and firms failed to differentiate between salary and profit distribution. When this happens the firms pay out most of their earnings in monthly draws to the partners. In fact, when asked what compensation means, the average firm partner would reply, "It's my biweekly draw." In other words, partners don't tend to differentiate between base pay, profit allocation, pension contributions, and other benefits and perquisites. That's not the way compensation is thought about in the business world.

Current compensation trends in professional services firms

Executive compensation in the corporate world is normally presented as "total compensation". This consists of base pay, short-term incentives (such as year-end and quarterly bonuses), long-term incentives (such as

options, other deferred or performance compensation, and retirement benefits), and other benefits and perquisites (such as health, disability, and life insurance).

What is fair partner compensation?

A big issue today is determining base pay. Some firms claim that they pay according to what they consider to be "market" compensation. That is a nebulous term that fails to define whether the firm is comparing itself with a market performer or an underperformer. Moreover, unless the firm's financial performance is at or above market, it will have trouble paying "market" year after year.

The question still remains – how do you determine base pay for a group of partners? I've yet to meet a partner who felt that he or she was overpaid. Although that may be a healthy attitude, it's not necessarily reality. There are partners who, undoubtedly, are underpaid for their contributions to the firm and, of course, there are others who are grossly overpaid. The cold hard fact for many partners today is that they could not go into the marketplace and replace their current compensation.

Nicholas J. Mastracchio, in his book *Mergers and Acquisitions of CPA Firms*,[1] says that a fair compensation (base pay) for owners (if they sell their firms) is based on the following formula:

Owners' salaries = staff (i.e. associates) salaries
x
owners' billing rates / staff billing rates

Why couldn't this formula be used to set base salaries for law firm partners? Here's how it could work. In "Best Service Law Firm" the associates have an average salary of $150,000 and an average billing rate of $175 per hour. The partners have an average billing rate of $275 per hour. Using the preceding equation, the partners in this firm would be paid $235,714 in salary.

Partner salary = $150,000 x $275 / $175 = $235,714

What is not measured is a partner's intangible contributions under this method. The intangibles and other goals would be recognized in a bonus program.

Paying for performance

Remaining income after base salaries are paid could then be paid out in bonuses or used for capital improvements. The strategic value of having such a compensation system is clear. Partners now have more of their income at risk and, as such, will not only perform at a higher level but also will help the firm achieve its strategic objectives. The questions that firms then struggle with are:

1. How should profits be distributed to the partners? And
2. What criteria should be used to determine profit allocation?

It is impossible for anyone else to answer these two questions for your law firm. The ultimate answer has to come from inside the firm, not from an outside consultant. Each firm needs to develop a system that works for it uniquely and helps achieve its strategic focus.

Performance bonus criteria

There are three main buckets that compensation criteria can fall into: economic; origination; and value enhancement. Within the economic bucket fall all activities that increase current profits of the firm. For example, increased billable time, higher realization, reduction in work in progress (WIP) and accounts receivable (A/R) days outstanding, etc.

The origination bucket has two sub-categories. First, new business brought in either by the individual himself or with others. Second, cross-servicing opportunities closed either by the individual herself or with others.

Finally, the value enhancement bucket, which includes intangible activities that will build future capacity for the firm but may not produce significant revenue for a few years. For example, a partner who develops a new service area such as drone law, or a partner who becomes known in the market place as the expert in a certain area.

Building the "near-perfect" compensation system

Consider the following best practices when building *your* compensation system:

- Compensation systems are self-funding unless the firm decides to borrow money from the bank to pay partners. Although this is not a very smart idea, I have seen firms do it;

- The compensation system should shape your firm's culture, rather than your culture shaping the compensation plan;
- Compensation systems should be flexible. As your firm and the external environment change over time, so should the system;
- Ownership means putting your compensation at risk. Partners should realize that, as owners, their "compensation" is never guaranteed;
- Compensation should be tied to results. Efforts are important, but results count more;
- Owners need to be held accountable for their own actions, or lack thereof;
- Compensation systems should measure multiple areas. A successful firm requires many different talents. It's like a sports team. Can you imagine a winning baseball team with all shortstops or a football team with all defenders?
- Seniority should mean very little or nothing when it comes to determining an individual's compensation. If that were the case, the oldest person in the firm would always make the most money;
- The system should be easy to understand and administer;
- The system should be retrospective. You want to pay the majority of the dollars at the end of the year, not throughout the year; and
- Because compensation is a management tool, only firm leaders should set compensation – and no one else. Period.

What should the system achieve? Nine goals

Every compensation system should have an endgame in sight. When you tie your system to achieving your firm's business success, you can aim for these nine goals:

1. Motivate partners to peak performance;
2. Modify partner behavior;
3. Retain the best partners and remove non-performers;
4. Attract desirable lateral hires;
5. Reward for results first and efforts second;
6. Drive business results and create value;

7. Focus partners on their own results and compensation, not on that of other partners;
8. Promote associates to partner based on economic and not just professional criteria; and
9. Create an equitable system over the long haul.