Paying and Transitioning Leaders

By James D. Cotterman

As we enter a new year, many law firm partners are taking on new leadership roles in their firms. These individuals may be running practices, offices, regions, special firm committees or the entire firm. The role could be limited to a specific issue undertaken in addition to everyday responsibilities for a short duration, or could require the entirety of their time and energy for many years.

When a law firm asks an individual to step forward on behalf of the group, it is incumbent on the group to define the scope, authority and expectations for the leadership position. In addition, there should be mechanisms in place to evaluate leadership performance, provide feedback and appropriately adjust compensation. It is common to hear partners talk about leader pay as a kind of "tax" on their own compensation. However, this so-called tax provides the firm with centralized management functions and hopefully generates the benefits of practicing in a more competitive law firm.

Firms seeking good leaders will not create them using compensation incentives. This will be no more successful than efforts to use origination credits to turn service partners into rainmakers. It takes talent, time and training to become an effective leader. The role of compensation is to appropriately recognize and reward a leader's contributions. Moreover, while compensation committees are getting much better at using pay schemes to recognize hard work and client generation, there remains great difficulty with appropriately recognizing, evaluating and paying for indirect contributions such as leadership.

How a law firm approaches leader pay depends very much upon the scope and scale of the post. The full-time worldwide managing partner role is vastly different from the part-time office head. Some roles are effectively handled within the existing partner compensation scheme; others may require a specially conceived program. The more limited the scope and time requirements, the easier it is to reasonably handle the role within most remuneration schemes. However, once the job has become significant in its time requirements – as it does with global managing partners – the firm must design a pay program that identifies the critical success factors for the position, and then builds feedback and pay around those factors. These programs are specifically geared to leaders, yet remain aligned with the firm's values and culture.

There are three principles that firms will often employ as their leader pay programs evolve. They are an evaluation of inputs, the establishment of a fixed payment and an evaluation of results. The method used is largely a product of the firm's size, management sophistication and the partners' collective sense of the appropriate role of a law firm leader.

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EVALUATION OF INPUTS

Historically, the compensation focus was on effort, largely to be consistent with how partners are measured generally or because the firm could not agree on how to incorporate leadership performance into the decisions. The most readily available input metric is billable hour equivalents.

Under this methodology, firms will discuss and arrive at an appropriate hours' budget with the incumbents for each position. Hours in excess of budget would be considered only upon approval and if the incumbent can justify why the additional time was required. This may occur in a year when the firm undertakes an office relocation, significant technology migration, merger exploration or other episodic and important event.

Many firms convert management hours into fee equivalents using a lawyer's average effective rate. While this technique is useful to compare partners on a basic productivity measure, one must be careful to realize that these are not real economic dollars. For that reason, it is advisable to "tax" all partners proportionally with the cost of the management fee credits.

While fair to the incumbent at least in terms of effort and time away from their law practice, this approach often leads to the firm's partners wondering what they are getting for that time and money. The next two principles grow out of those concerns.

ESTABLISHMENT OF A FIXED PAYMENT

Paying a stipend based on the demands of the job, as agreed to by the partners and the leader, lets everyone know in advance what this job is worth to the firm. Besides its simplicity, this approach also prevents management time run amok, a common concern when inputs drive the pay decision.

An enhancement of the fixed payment approach adds periodic adjustments based on the job's actual and evolving requirements. Finally, adding a bonus provision based on results, helps differentiate good leader pay from underperforming leader pay – an important characteristic in well-functioning pay programs.

EVALUATION OF RESULTS

Not satisfied with the first two principles, many firms eventually move on to an assessment of the leader's performance. To provide context for evaluation, results are compared to a plan, budget or forecast.

Sometimes firms will also compare actual results to market conditions – recognizing that a bad year's performance may reflect good leadership if the firm withstood an economic storm better than its competitors (think about the recent recession) and a good year's performance may not reflect well on leadership if the market easily outperformed the firm.

Some firms will tie some portion of pay to actual performance metrics such as a percent of firm fees, or a percent of the partner income pool. Such an approach is simple and clearly aligned with important metrics. However, it may also focus thinking on a very short time horizon.

VALUING EFFORTS, RESULTS AND RISK

Ideally, leader pay schemes should recognize efforts, results and risk. Many initiatives undertaken by law firms require efforts long before results are known. Likewise, many initiatives have timeframes that far exceed the annual compensation cycle. Finally, good leaders must accept risk as an inherent part of their job. Smart, strategic risk should be evident in the firm's competitive strategy.

The best businesses take risks — innovation, growth, responses to rapid market changes and the ability to discern longer-term shifts all involve risks. Procter & Gamble's chief executive, A.G. Lafley stated, "You learn more from failure than you do from success, but the key is fail early, fail cheaply, and don't make the same mistake twice." (*Business Week, April 2, 2009*) If a law firm wants to implement strategic objectives in a competitive and changing market, it will want to encourage smart, strategic risk-taking and consider including informed risk taking in the remuneration scheme.

Valuing leadership is the next hurdle. The profession has largely accepted that leadership has value, yet there remains some level of discomfort according it equivalent status to a partner's thriving law practice. A better approach is to ensure that leaders are not disadvantaged with respect

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to pay opportunity relative to their front-line practitioner colleagues. At the same time, that assurance should not protect the leader from being held accountable for performance, nor sharing in the overall fortunes (good or bad) of the firm. This balance is best achieved by calibrating a leader's pay to yield a decision that compensates at about what the individual currently makes as a full-time practitioner if the firm performs at the same level, more if they advance the firm's performance, or less if they dilute performance. Substitute for "firm" any other term that describes what the individual has responsibility for, such as practice group or office.

TRANSITIONING OUT OF LEADERSHIP

The final component of the leader pay decision comes at the end of the leader's term. Law firm leaders used to be older when they entered these positions and could easily retire afterwards. Today we see more and more fifty-something leaders who are ready to step down from their posts after five or ten years. Still in their 50s, most do not seek to leave their firm or their law practice. Yet for many, particularly those who have left the practice entirely for ten years to serve the firm's interests, the return presents some challenges and questions. One of those questions is, "What happens to my compensation?"

While this issue is generally limited to managing partners, we are beginning to see some of it at the office and practice leadership roles at the very largest firms where the duties of their positions are quite extensive.

If there is a "general rule" to apply to this situation, it has been to hold the former managing partner's compensation at its current level for one year for every two years served, with a cap of three years protection. Perhaps a modern equivalent, with a slightly more nuanced approach might look like this. Upon leaving, there will be one year of no adverse adjustment from the average of the last three-year's compensation position for each two years in the post, up to a maximum of three years protection.

Compensation position is different from compensation amount. Position considers the individual's actual compensation relative to average, top, median and entry-level partners. The protection seeks to maintain the "sustained position" (hence the average of the prior three years) as a floor for compensation of the leader during the protection period. This provides for the compensation to go down if the overall profitability of the firm declines.

However, when a specific program is being developed, the typical or nuanced approach becomes a bit tricky unless the firm simply desires to provide an unencumbered entitlement to the departing leader (which may be fine as well, if it is deliberate).

Beyond post-leadership compensation, a more fundamental question is particularly important to managing partners. In a nod to a holiday movie favorite, White Christmas, "What do you do with a managing partner, when he stops being a managing partner?"

A number of variables drive the answer to that question: firm size, incumbent age, firm governance charter, practice area, clientele and the like. What might make sense for the 70-year-old managing partner of a ten-partner firm who is retiring at the end of term almost certainly will not make sense for the 50-year old managing partner who after ten years leading a 200 partner firm is very much interested in returning to his or her law practice.

It is important for the firm to engage in a dialogue with its exiting managing partner. There are many factors to consider depending on the unique circumstances involved.

- Is this discussion for an imminent event or preparation for something some time off in the future?
- How long has the person been in the position?
- Was the position full-time (involving a turnover of client relationships and cessation of practicing law)? If not, how much did the leadership post intrude on practicing law, business generation and market presence?
- What kind of practice and client following did this person have? Transactional practices are different from advisory practices. How permanent was the client relationship transfer?
- How visible was the post in the market (i.e., did it have a high public profile or was it more of an internal orientation)?
- What is the expected role of an incumbent upon leaving the post (is there any transition, formal or otherwise expected of this person)?

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- What kind of compensation program does the general population of partners work under?
- Does this leadership post have any particular variation or customized pay scheme?
- What does this person want to do? We know individuals often say that they want to return to their law practice, but there are varying degrees of that statement and it helps to understand what each side is thinking.

The best leadership transition program is one that works to meet both individual and firm interests while considering the challenges and timeframes to transition from the formal leadership role into the next role — whatever that may be.

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