Compensation Best Practices

By
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I am often asked about law firm compensation best practices – what is the best way to compensate partners? Most people expect to hear a response regarding a particular compensation methodology or process, but that's not the case. The answer is more complex, and getting there has been a multi-decade-long evolution of Altman Weil's compensation advisory services.

The Evolution: 25 Years of Law Firm Compensation

In 1990, compensation advisory services focused primarily on benchmarking – reviewing survey data, finding comparables, refining the survey comparables to adjust for survey timing differences, then determining appropriate compensation ranges. Driven by a market that was experiencing rapid shifts in lawyer compensation, law firms were focused on external competitiveness based on experience, location, expertise and size of firm.

After the early 1990s recession, law firms wanted to concentrate more on compensation system design, largely because they perceived a need to be more economically rational during difficult times. Partner performance was measured by very specific factors for which the firm would pay (compensable contributions led by business origination and personal productivity). Each contribution had to be defined, then measured, and finally valued relative to all other contributions. Benchmarking against other law firms receded in importance as the market downturn quieted the starting-salary market, relieving upward compensation pressure throughout the ranks.

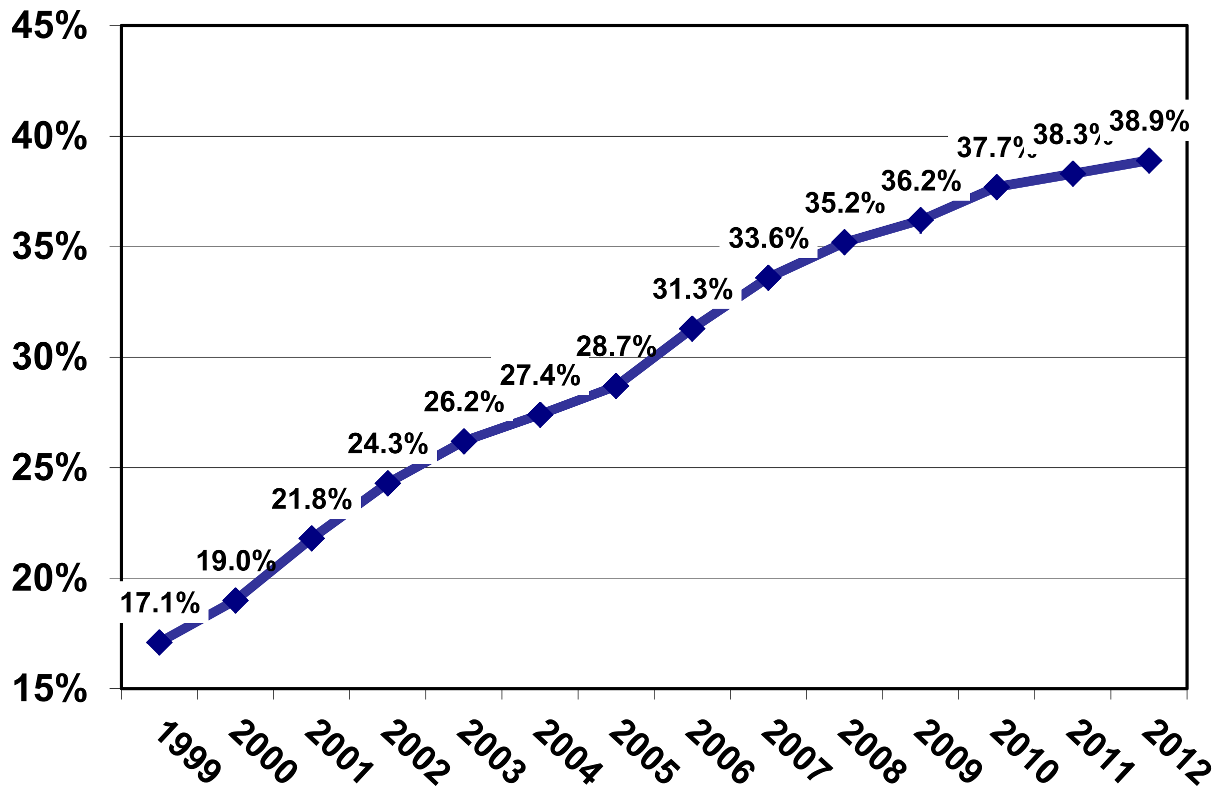
It was during that period (the early 1990s) that we began to seriously study the lawyer compensation market and in particular partner pay programs. We began with a premise that system design was not the core issue. Lacking extensive research, but armed with our experience assisting law firms with compensation issues, we felt strongly that all compensation systems can "work" and all compensation systems can "fail." How else could one explain the paradox that a particular approach worked in Firm A and failed in Firm B? We also noted that each firm tended to put its own peculiar spin on a few core compensation elements.

In 1993 we began our first research into compensation methodologies — the *Altman Weil Compensation Systems Survey* — which yielded the first systematic look at how compensation decisions are actually made in private law firms.

As the decade of the 1990s continued law firms started asking about process as well as system design. These firms were not getting the results they anticipated from "improving" their compensation systems. Their dissatisfaction stemmed largely from a belief that compensation was an effective motivator — and in some cases from an unstated assumption that compensation could serve as an effective proxy for good leadership and management practices.

By the end of the 1990s, the starting-salary market took off again. Lawyer mobility, not just within the profession but increasingly away from the profession and to high tech ventures with equity participation, was becoming an acute problem. And use of non-equity partnership created a significant upswing in the importance of the law firm staffing model. A central issue became how to get more dollars to the firm's stars and rising stars to stop competitors from poaching talented lawyers. This concern continued into the new century.

Non-Equity Partners as a Percentage of All Partners in AmLaw 200 Two-Tiered Partnerships 1999 to 2012



As 2000 unfolded, the market began to turn, and a recession was rapidly underway. Firms burdened with partners who could not keep themselves or others sufficiently busy now sought advice on getting compensation rationalized, as well as on ownership structures and criteria for defining a fully contributing partner. To many firms, "rationalized" meant not only aligning pay with performance but also setting far stricter expectations for partner performance. This focus repeated itself less than a decade later, on a much larger and more disruptive scale, during the Great Recession.

Corroborating Research

In 2001 two excellent research studies were published. One dealt with professional services practices *(Practice What You Preach*, by David Maister*)*, the other with large public corporations (*Good to Great*, by Jim Collins). Each examined high-performing organizations and concluded that the method of compensation is largely irrelevant as a causal factor for high and sustained performance.

As David Maister put it, “Those who contribute the most to the overall success of the office are the most highly rewarded. Notice that this does not suggest what the pay scheme should be. The determining factor is just whether the people think it rewards the right people” (*Practice What You Preach,* p. 50). He also observes, “The most striking finding is that the most financially successful offices did better at *virtually everything*” (p. 28).

Jim Collins similarly reports, “We found no systematic pattern linking executive compensation to the process of going from good to great. The evidence simply does not support the idea that the specific structure of executive compensation acts as a key lever in taking a company from good to great” (*Good to Great*, p. 49). He goes on to say, “The purpose of a compensation system should not be to get the right behaviors from the wrong people, but to get the right people on the bus in the first place, and to keep them there” (p. 50). And finally, “Those who build great companies understand that the ultimate throttle on growth for any great company is not markets, or technology, or competition, or products. It is one thing above all others: the ability to get and keep enough of the right people” (p. 54).

Again the quality of the decisions being made about people — hiring them in the first place, the careers they follow, and the recognition decisions about their performance — are what the firm must get right. Any specific compensation system may or may not be the right structure for an organization to achieve that end.

The Best Practices

The best practices for law firm partner compensation decisions are those that demonstrate:

1. Internal consistency—Pay Proportional to Performance®.
2. Strategy linkage—Recognizing smart, informed risk-taking efforts and results appropriately.
3. Cultural alignment—Supporting the group’s agreed-upon values and desired work environment.
4. External competiveness—Effectively managing departure risk created by under-market compensation.

One can assess the quality of decisions with the following questions:

1. Would an independent observer look at the basket of contributions, their relative importance, individuals' total contributions and the corresponding pay decisions and reasonably conclude that those who contributed more to the organization's success were remunerated proportionally more than others?
2. Is the message of what is important from a strategic business perspective clear and aligned with how pay is determined? Are smart risks rewarded, even if unsuccessful? Are efforts and results each appropriately considered?
3. Are firm values and the desired work environment considered? Will a person's behavior affect compensation in an appropriate and meaningful way?
4. Are the pay decisions competitive with what is available in the market or at least what is available in other similarly situated organizations? If this cannot be accomplished across all partners, is it at least being done to effectively manage departure risk of stars and rising stars?

A second area of best practice is communications. It is simply not sufficient to believe that compensation decisions will stand on their own merit and be interpreted by the recipients in the same way as firm leaders intended. We have tested for this and found that even compensation decisions that are positive may not be interpreted correctly by the recipient, particularly if the individual's expectations differed from the result. The following questions can assist in assessing the communication effort:

1. Are the communications candid and constructive?
2. Are they bi-directional? The partner compensation process tends to be high touch, with partners providing input in advance of decisions and receiving feedback after decisions.
3. Do you discuss how a decision was reached and how an individual can increase his or her compensation in the future? Are the right people involved in that conversation? Many firms fail here.

Equitable Compensation Decisions

The equity theory in compensation says that there is an appropriate pay range for every job. Many businesses look at the market and benchmark the range between the lower quartile (the point below which 25% of the job holders fall) and the upper quartile (the point above which 25% of the job holders fall) – otherwise known as the inter-quartile range or middle 50%. This market range concept was not developed for law firm partners, but the underlying theory holds. There is an appropriate range of pay for any job and performance variation within that job.

Good compensation decisions must be equitable. An equitable decision does not necessarily mean that there is a single, objectively "right" or "correct" decision for each individual. Compensation decision-making, even in formulaic systems, is not that precise, nor will it convince each person of the wisdom and fairness of that amount they receive. Rather a major goal in making equitable decisions is for a super-majority of the individuals in the firm to strongly agree that, on the whole, those whose labor (efforts and results) contributes more long-term value to the organization receive higher compensation (wages and benefits).

In addition to the basic goal of having compensation align clearly with contribution, research shows that the fairness of compensation is judged by two other factors: perceptions of what other organizations pay for similar work and the employer company's profitability (*The Enthusiastic Employee*, Wharton School Publishing, 2005, p. 12).

The Importance of Pay Proportional to Performance®

This is the internal equity component. People want to be treated fairly. Typically their reference points are what other individuals are paid, what those individuals are contributing, and how they themselves compare to those other individuals.

The fundamental notion of "contribution" in law firms is that partners must be personally productive *and* proficient at generating clients. However, most firms also look at many other factors to evaluate an individual's total contribution. Those factors include work/service quality, management/leadership, marketing/firm promotion, development of oneself and others, fiscal stewardship, good corporate citizenship and the like.

Achieving internal equity requires careful consideration of the total basket of contributions that each firm values – including how to measure the performance, its relative importance for that individual and overall, the trending direction (improving, static or declining) of that performance factor, the appropriate consideration of efforts and results, risks taken and lessons learned. Doing this well requires mechanisms to facilitate a consistent and thorough assessment of each individual, and to ensure that each evaluator is undertaking the review in a similar manner.

The Power of External Competitiveness

This is what other firms pay for similar performance. When firms benchmark compensation they examine many variables but often fail to factor in performance. Pay should be in line — competitive — with the market for similar performance. This is greatly affected by a particular firm's profitability (see below).

The performance factor that most highly correlates with lawyer compensation is personal productivity as measured by fees collected. In large surveys that use the time value of hours worked as a proxy for fee receipts, the correlation factor is 68%. When assessing individual firms using fee receipts, the correlation factor is consistently at similar levels. It is also interesting to note that this factor (revenue per timekeeper) most highly correlates with high law firm profitability.

Partners also contribute by generating client work. Indeed, demonstrated business development ability is a critical element of the requirements for a fully contributing partner (see my articles, *Who Should Be a Partner in a Post-Recession Profession, Parts I & II*). The highly active and competitive market for lateral partners illustrates this through its emphasis on the portfolio of work that will come along with a lateral partner and his/her team. Historically measured by the gross revenues, books of business are now examined more closely to understand how a new portfolio will contribute to partner profits and competitive position. Only occasionally does a particular expertise, skill, experience or geographic presence (including the jurisdiction license, local knowledge and contacts) drive the recruitment decision.

While other attributes are also vital, these two economic contributions (personal productivity and new business origination) are really the heart of what sets the most significant portion of partner compensation in a private law firm. The two combined typically explain between 82% and 87% of the compensation decision. The remaining 13% to 18% is explained by other factors.

It is important to understand that market decisions are economically rational. Even in those firms that use a lock-step methodology – unusual in the United States – market forces prevail. These firms achieve economically rational results through an extremely strict tournament to get invited into the equity ranks and then careful monitoring of each individual's career growth once there.

The Role of Firm Profitability

The firm's profitability is important because it will affect the ease or difficulty a firm has in meeting the criterion — competitive alignment with external pay. Firms with high overhead (the fixed cost of operating the business) relative to revenue and/or low margin (the profits generated by other timekeepers) will struggle to get pay to market levels. However, partners in such firms are more likely to accept the differential if the overhead burden and margins are consistent with their firm's operating philosophy. However, the difference between the market and the firm should not become too great for too long, as partners' tolerance is unlikely to last forever. We often find compensation programs that operate well initially but suffer over time from the results of poor owner decisions and management execution.

The 2014 Compensation Tune-up

We generally recommend a review of compensation programs every several years. This does not have to be led by an external consultant each time. But it is good to revisit the best practices presented herein and consider how your program is serving your firm.

Firms change over time as partners come and go, markets evolve, practices grow and wane and clients' needs/preferences change. The compensation program must evolve in response. Slow incremental adjustments are easier to implement and create less disruption than more substantial, episodic overhauls.

Key issues law firms are dealing with in 2014 are not necessarily new, but they represent persistent challenges firms face. These issues include the underproductive partner, the non-equity partner model (pay, structure, and management), the retiring boomer generation cohort group (including succession and transition issues), paying key partners, paying leadership (particularly the Managing Partner in very large firms), disruptive partners and communications (managing expectations, linking input and feedback with strategy and values). Each of these has pay and non-pay elements that are intertwined.

Summary

Equitable compensation decisions are important because they engender trust and credibility in firm leaders and managers. These decisions are the most tangible expression of what is valued in a law firm. When aligned with leaders' stated priorities, trust and confidence is enhanced. When they are misaligned, trust and confidence wanes. While good compensation is unlikely to drive performance, inequitable compensation decisions will hurt morale and consequently diminish performance.

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