Subjective Law Firm Compensation Systems, Marketing and Origination

By Alan R. Olson

Editor’s Note: This is the second article in a two-part series. The first was entitled “Marketing, Origination and Formulaic Law Firm Compensation Systems” and appeared in the March 2003 issue of RTLM. The two articles can be read in conjunction with each other, or separately, as each has value without the other.

With the increasing intensity of competition in the legal market, rewarding and providing incentives for marketing, client retention and business development has become more and more important to law firms. Law firm compensation systems are a major tool to stimulate individuals to act in the best interests of the firm and to help the law firm better adapt to its external environment. An ineffective compensation system is likely to reduce profits at a minimum and can even destabilize or help destroy a firm. In the 21st Century, failure to consider business development is likely to reduce the effectiveness of a law firm’s compensation system and may even lead to more serious damage.

This article will explore the interrelationship of marketing, origination and subjective law firm compensation systems. The goal is to provide a representative overview of the treatment of marketing in subjective compensation systems, recognizing that there are innumerable variations in subjective systems and the ways in which they are applied. In the current legal market, virtually as many law firms use subjective systems as use objective systems, or use combinations of subjective, objective and occasionally, some other type of system, such as lockstep. This is illustrated by the table on the following page from the Altman Weil 2000 Compensation System Survey, where the number of law firms using subjective systems, objective systems, and combination of objective and subjective systems are virtually equal. We predict that the soon-to-be-released Altman Weil 2003 Compensation System Survey will show an increase in combination systems and probably, in subjective systems, based on the slight overall shift away from objective systems we are seeing and sometimes recommending in our law firm consulting engagements.

The Importance of Measurements to Subjective Systems

Perhaps surprisingly, the necessity of measuring and tracking performance metrics like working attorney collections, business billed and originated, hours and realization, are just as important in subjective systems as in formulaic systems — and in some senses, may be even more important. For most firms, the effectiveness of a subjective system goes up with increasing scrutiny of performance figures — subjective systems are more effective when they rely heavily on objective data.

The precision with which data is collected may be less significant in subjective systems than in formulaic systems. For example, if a lawyer, in a subjective system that looks at collections, collects a major fee just after the firm’s fiscal/compensation year, the delayed collection can be treated either severely or more generously by the compensation committee, by looking at the billings and viewing the year-end with some elasticity. In a formulaic system looking at collections for that year alone, the lawyer would be out of luck for that year, hopefully consoled by the prospect of more income in the upcoming year.

Examples of Subjective Systems, Marketing and Origination

We will describe five subjective compensation systems and their treatment of marketing and origination, beginning with a combined objective-subjective system, moving to relatively structured subjective systems, then to less structured systems.

System 1: Tiers Based on Working Attorney, Plus Originations

Compensation tiers are set based on working attorney collections, minus overhead per lawyer.
Example:
- Set tiers in $10,000 increments, from $100,000 to $250,000 ($100,000, $110,000, etc.)
  - $250,000 in working attorney collection, minus $100,000 in overhead equals $150,000 — all things being equal, that individual’s compensation would be in the $150,000 tier.

- Base movement upward and downward in tiers on origination.
  Example:
  - If less than $100,000 in origination, move down two tiers to $130,000;
  - If less than $200,000 in origination, move down one tier, to $140,000;
  - If $200,000 to $250,000 in origination, remain at $150,000; etc.

- Origination can be interpreted simply by origination collection reports, but can be determined more broadly by reviewing additional information, including origination collections, new business origination, billing attorney collections, number of other lawyers and paralegals kept busy, realization on work originated or billed by each lawyer.

System 2: Tiers Plus Originations, with Rolling Averages

The firm can use rolling averages to smooth transitions, or add other features.

In the preceding example, movement up or down between tiers could be based on a rolling average, such as the one-year average of the last two years’ performance. As with its application in formulaic systems, rolling averages can reduce or prevent wide swings up and down. If a subjective system is using the dollar values in tiers relatively rigidly, calculation and review of rolling averages become more important.

System 3: Rank of Tier Origination

Rank origination by lawyer into tiers. Subjectively raise/lower compensation amounts.

Example:
Rank lawyers in one of three tiers for origination bonuses, as:
1) Net exporter of work to others
2) Self-sustaining
3) Net importer of work from others

Lawyers in Tier 1 would receive 2 credits; in Tier 2 would receive 1 credit; and in Tier 3 would receive 0 credits.

An origination bonus pool, for example, 30% of net profits for distribution to partners, would be divided based on credits.

Ranking could be based on none or many reports — but is most effective when based on at least a few on-point reports. These could include origination, possibly new business origination, billing attorney credit and realization. Review of other factors, such as working attorney collections and time devoted to firm management, may also be relevant. If origination collections are much higher than one’s working attorney credit, this typically means the individual is delegating work to others. Significant time devoted to firm governance may in part explain lower origination figures, and could even mean time devoted to firm marketing activities.

System 4: Subjective, With Set Pools and Weighting of Factors

In this example, an origination pool is established for a retrospective year-end bonus:
- 15% for total origination/book of business; and
- 15% for new business

Total of 30%

Business origination collections and new business origination collections

<table>
<thead>
<tr>
<th>Which of the following best describes the method of valuing owner contributions?</th>
<th>2 to 19 Lawyers</th>
<th>20 to 49 Lawyers</th>
<th>50 to 99 Lawyers</th>
<th>100 or more Lawyers</th>
<th>Total</th>
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<td>Objective</td>
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<td>Subjective</td>
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<td>Lock-step or equal sharing</td>
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Which of the following best describes the method of valuing owner contributions?

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are reviewed and used as guidelines for dividing each of the two pools. Use as guidelines differentiates this system from an otherwise similar formulaic method, which would rely on actual calculations.

For example, two partners with approximately equal origination and new business origination could:
- Receive the same bonus amounts;
- Or receive significantly different bonus amounts, if:
  - Partner A worked alone, and
  - Partner B, in addition to developing his/her origination collections, helped others develop work, introduced clients to others in the firm, who then developed work in “their columns,” and/or performed non-billable marketing activities for the firm.

As indicated by this example, one potential advantage of subjective compensation systems over their formulaic counterparts is the ability to consider contributions that may not be quantifiable, such a consideration of marketing efforts on behalf of the firm as a whole. Another example of appropriate subjectivity may include consideration for someone who saves a major client from departing the firm, which would probably show up in billing attorney collections, but seldom in new business origination.

**System 5: Set Pools, Subjective Determination**

To illustrate, an origination pool of 25% of total net profits is established for retrospective year-end bonus. Reports are specified for review, such as billing attorney collections, new business collections, individual goal-setting materials completed by each attorney at beginning of the year related to productivity, marketing, management and other goals/factors, year-end self-reports tied to the goal-setting factors and manager reports.

The compensation committee reviews the reports, meets with the individuals and decides how to divide the origination pool based on analyzing the reports and other reasonable considerations.

**System 6: Total Subjective—“In the Eye of the Beholder”**

In a totally subjective system, weighting is subjective — “in the eye of the beholder.” There are no set reports. Each member of the compensation committee or partner group identifies what he or she thinks is important. Since such systems are inherently informal and undocumented, it is difficult to estimate its frequency of usage in law firms. It is probably used frequently in small firms, more or less intentionally. In all firms, it is sometimes used unintentionally, as when the compensation system evolves away from the originally documented system or when compensation committee members make a de facto change.

Altman Weil’s consultants find it difficult to justify totally subjective systems.
These systems generally fail to sufficiently identify, or explicitly reward, marketing and new business generation as well as other firm activities.

**Conclusion**

In the competitive legal market, compensation systems are an all-important adaptive mechanism for law firms, enabling firms to stimulate and reward activities in the best interest of the firm and its individual lawyers. Marketing, client retention, client expansion, and new business development are among critical activities to be addressed by partner level compensation.

Subjective systems help a law firm stimulate and reward marketing activities and origination and can encompass more aspects of marketing and origination than more rigid formulas. Perhaps ironically, it is just as important for subjective law firm compensation systems to focus on objective performance data and reports as a basis for analysis as formulaic systems. Otherwise, those administering a subjective system will not have an effective basis for consistency. Even when a subjective system without an objective foundation or criteria is applied diligently and consistently, the lack of criteria renders the system inscrutable to those outside the compensation committee or group, perceptions of unfairness are likely to grow, and the system will become ineffective, or even destructive, to a law firm.

This article has provided an overview of subjective systems and components for considering and measuring origination. Some of these resemble formulaic systems, with substantial structure; others are highly subjective. As with any law firm compensation system, none of the systems should be applied in a particular law firm without significant analysis and evaluation.

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