Altman Weil, Inc.
The leader in legal consulting.

Compensation Committees' Most Common Errors

By James D. Cotterman

"How can you think and hit at the same time?" – Yogi Berra

Making compensation decisions about one's peers is arguably the most difficult task in law firms. You do it once a year in a compressed timeframe. The job is asymmetrical – lots of downside risk for getting it wrong and limited upside opportunity for getting it right. The good news is that you are more likely to get it right than you would be to get a hit in Major League Baseball.

Here are the most common errors we observe and some thoughts on how to address them in your law firm:

TOO MUCH COMMITTEE TURNOVER

Short duration terms and term limits prevent experienced, consistent decision making and development of institutional knowledge. Good compensation committee skills and historical context generally take three years to develop; yet the average committee term is under two and one-half years, and nearly a third of firms limit participation to one term.

NO MANAGEMENT PARTICIPATION

Concerned about concentration of authority, partners will often set up independent compensation committees. This occurs in about one in four firms, and can undermine two of the best practices in partner compensation: 1) recognizing smart, informed risk-taking efforts and results related to firm strategy, and 2) supporting the group's agreed-upon values and desired work environment. Isolating management from the compensation process strips them of their most effective means of walking the talk about what behaviors are valued by the firm.

NONEXISTENT, LIMITED OR INEFFECTIVE FEEDBACK

Admittedly, firm size plays a significant role in how much process is typically involved or appropriate for compensation decisions. Also important is the approach taken – formula, subjective, or lock-step/equal-static share. However, far more firms conduct pre-decision interviews or obtain written submissions from partners, than consistently offer feedback on their decisions. And when it is offered, it often is only for problem partners or upon request of a partner. This has improved over the past decade, but not nearly enough. The problem is exacerbated by the increasing importance of intangibles in making decisions, without a commensurate shift in more robust feedback to provide the context and nuance necessary to understand a decision and its meaning.

A STUBBORN RESISTANCE TO SHIFTING ORIGINATION CREDITS

While not representative of the behaviors that make for a collaborative firm, the market rule is that origination belongs to the individual who can 'walk out the door' with the client[1]. However, a move away from a single definition of origination can facilitate a more effective recognition and allocation of origination credits. Begin at the beginning by asking and answering three questions:

- "Why does work come to the firm?"
- "Why do we keep that work?"
- "Why do we get more of the client's legal spend?"

Then reach an accord with your partners on what origination looks like and how it should be allocated. This common protocol will simplify what the committee does, as well as the integration of new partners into the firm.

A growing corollary to this problem is younger partners' expectation of passive inheritance rights to retiring partners' clients (and origination credits) without an appropriate investment in those client relationships. Compensation committees should encourage firm leaders to address this significant sustainability issue — which will enable them to recognize and reward younger partners who are contributing to client sustainability and take other action with those who are not.

LACK OF CONSISTENT METRICS TO DIFFERENTIATE INTANGIBLES

How much and how well an individual partner contributes to the success of the firm outside of the traditional roles of practitioner and business generator is difficult to evaluate, and the conversations about that assessment are themselves quite subjective. Where formally evaluated, the typical three factor scale of "does not meet," "meets" and "exceeds" expectations is not very helpful if expectations are not well defined. Also the typical five point scale ('excellent' to 'poor') lacks consistency on just what those terms mean from partner to partner. There are tools – called rubrics – that can better frame the expectations and performance levels. Rubrics offer a concise description that paints an image of what each level of performance looks like for each specific intangible[2].

'FIXING' PERFORMANCE PROBLEMS WITH COMPENSATION REDUCTIONS

A frequent inquiry from compensation decision makers goes like this, "What is wrong with reducing compensation for unproductive partners?" The problem is that it says, quite clearly, that there are no performance standards. Standards, like minimums, are not meant to be aspirational; they are meant to be requirements. Reducing compensation meets the best practice of Pay Proportional to Performance®, but it does not address the underlying problem — a lack of performance. And more often than not, once compensation is reduced the individual's performance and attitude gets worse, not better. To solve a problem, you fix the problem. The compensation reduction may also be necessary, but don't mistake it for a tool to improve performance.

SENDING A MESSAGE

Many Compensation Committees believe that their decisions send a clear message. The author has tested this hypothesis by debriefing with compensation committees on the intended message of their decisions, and then interviewing the individual partners to learn their perspectives on the decisions and their place in the firm. Generally the match-ups were not very good. Even messages for stars and rising stars were not well aligned between intended message and received message. Compensation is a lousy messaging tool. There is no way around it — you need to have a conversation that explains the decision and how the partner can improve going forward. Make sure the right people are participating — typically a compensation committee member and the partner's practice group leader.

PROCESS WITHOUT PURPOSE

Each interaction has a specific purpose and a proper constituency. Ensure that both you (the committee member) and the individual partner are contributing to that purpose. Why do you ask for partners to prepare some sort of written submission or answer a questionnaire? How do you control the content, length and focus of the submission? Why do you have briefing books with reams of data and stats? Why do you have pre-decision interviews? Why do you prepare a compensation committee report? What are the appropriate topics for that report? Why do compensation committee members discuss process at partner meetings? What is the purpose of feedback? Why might you have mid-year check-in conversations? How do you convey that you read, listened to and thoughtfully considered each input you asked the partner to provide? All too often there is insufficient strategic thought given to each facet of the compensation process. These are all communication based and provide the transparency and context for understanding and confidence.

RUSH TO IMPLEMENT PROFITABILITY ANALYSIS IN COMPENSATION DECISIONS

This is likely a surprise entry. I wholeheartedly agree that the profession is correct to move towards incorporating profit contribution into their compensation decisions. The likelihood that two equivalently sized gross practices are consuming markedly different resources and yielding markedly different profit contributions is high. My objection is that before you run with this in compensation, it is better to walk with it as an operational tool.

Let your finance team design and build it. Carefully consider cost allocation and profit contribution analysis. Communication and engagement are essential, as this is an iterative process and a learning exercise. Understand the level of practice interdependency and how that interrelationship factors into the profit models and eventually the resulting compensation decisions. Do not succumb to the temptation to micro-assign costs. The level of detail should be sufficient for rational decisions, but not so extensive as to create unnecessary cost or burden. Be mindful of who you are culturally, and design something that reinforces the value system.

Select a team to beta test the finance team's work, including roll-out training. Make refinements based on the beta tests and continue until the fundamental approach, the end-user tools and the training/support are geared to your needs. Then extend it to rest of your firm. Once partners are up to speed, give them a timeframe to show improvement. At this point, you can start holding partners accountable for using the profit tools and incorporating their efforts and results in compensation decisions.

James D. Cotterman is a principal with management consultancy Altman Weil, Inc. He advises law firms on compensation, capital structure and other economic issues, governance, management and law firm merger assessments. Contact Mr. Cotterman at (407) 250-6869 or jdcotterman@altmanweil.com.

ENDNOTES

1. Notably the market is characterized by firms who keep less work than they expected when a partner departs and departing partners taking less work with them than they expected, coupled with a newly emerging trend of clients shifting work elsewhere when partners shift firms. Better said, some clients are tiring of being treated as compensation leverage and are taking the opportunity to break old relationships and shift work to other firms that have been courting them.

2. Sample rubrics are available from Altman Weil.