

Report to Legal Management

MARCH 2003
Volume 30, Number 6

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Marketing, Origination and Formulaic Law Firm Compensation Systems



Alan R. Olson

By Alan R. Olson

Editor's Note: This is the first of a two-part series on law firm compensation systems. The second installment will appear in next month's issue.

With the increased importance of marketing in the universe of law firm priorities, incentivizing and rewarding marketing in law firm compensation systems is receiving more and more attention. The table on page 3, taken from the Altman Weil 2000 *Law Firm Compensation System Survey*, shows that business origination was the most important compensation factor, in a virtual tie with (but edging out) personal fees collected. See the first and last rows (the lower the number the higher the ranking). In the Altman Weil 2003 *Law Firm Compensation System Survey*, due out shortly, we expect that business origination will hold a similar ranking.

In this article, we will explore the inter-relationship of marketing, origination and formulaic (a/k/a objective) compensation systems. The goal is to provide a representative overview of the treatment of marketing by formulaic compensation systems, ranging from pure formulas to less rigid, but still fundamentally objective, systems.

Measurements — Converting Marketing to Origination to Compensation

Formulaic systems involve the use of one or more mathematical calculations to derive

a credit, a percentage or a dollar figure that results in compensation distributions or divisions. Therefore, to understand formulaic law firm compensation systems, it is necessary to first focus on the need to convert activities and behaviors into numbers that can be measured and calculated, to form the basis of a currency. While this is particularly true of formulaic systems, it is also applicable to subjective compensation systems in law firms.

Working Attorney Collections

Working attorney collections, which measure the collections received for work that a lawyer performs him- or herself, can be used to measure marketing or business origination, but only generally. Unless a law firm is comprised of very independent practices, like an office-sharing group of lawyers each of whom personally serves the clients

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Marketing... *continued from cover*

he or she brings in, lawyers will be developing some legal work that they distribute to others and do not perform personally. And, lawyers *should* be developing work that they distribute to others and do not perform personally — that is a major reason for specialization, for teamwork and ultimately, for having a law firm in the first place.

Billing Attorney Collections

“Billing attorney collections,” which measure the collections of the clients that one is responsible for billing, are more on the mark in rewarding marketing and origination than working attorney collections. In many cases, the lawyer billing the file is also in fact responsible for the overall client relationship, and that may well have derived from bringing in the client in the first place. Many lawyers will refer to billing attorney figures as a “book of business,” with the inference that if you bill it, it’s your “book.” Some firms measure personal working attorney collections and billing attorney collections and call it a day.

If a firm is trying to maximize its marketing performance, however, relying on billing attorney credits to measure marketing falls short. To perform optimally, lawyers in a firm must cross-sell other lawyers and practice groups to prospects and clients. The need for cross-selling to maximize performance increases with a client’s breadth of legal service needs and sophistication. This increases the likelihood — and one could argue, the necessity — for sending billing responsibility away from the initial rainmaker to the person actually responsible for the work, at least in many situations.

Some firms handle this by developing an additional “responsible attorney” category, crediting lawyers who are actually managing the matter, and sometimes, *de facto* managing the client. To some extent, this allows the

billing attorney category to more closely resemble a combined business developer and book of business category, which is a hybrid more closely resembling origination.

Origination Collections

Simply put, “origination” includes the development of business for the law firm. While the term connotes creation, as in new business, it can be tricky in practice. Some firms reward origination essentially in perpetuity, whereby a client developed 30 years before may still lead to the lawyer’s being rewarded with origination credits for compensation purposes. In some firms, clients and origination credits can actually be passed from one lawyer to the next, even after many years. In such arrangements, the distinction between origination and billing attorney, or book of business, greatly diminishes. More importantly, rewarding origination in perpetuity can work against the firm’s best interests over time, because individuals may focus too much on tending their existing gardens (or sometimes, on ingratiating themselves as potential heirs), and too little time on hunting and gathering new business.

New Business Origination

In new firms, or when a system rewarding business origination is relatively new to a firm, there is better rationale for considering all origination dollars more or less equally, and the negatives from origination that has gotten too old have not typically risen to a level of concern. At some point, however, firms tracking and compensating based on origination will at least wrestle with whether or not to differentiate between new business origination and older business origination.

Defining new versus older business can be difficult. An approach applied by Altman Weil in some firms involves imposing a “sunset” on all new business, typically two or three years after client acceptance or first billing date. At that point, either new business credit ceases, or is reduced. Other compensation credits, such as billing attorney credit and working attorney credit, would remain in most systems and can ease the abruptness of the reduction in new business credit. Of course, as described above, the new business originator should not always be the billing attorney in many kinds of practices, or the working attorney either.

Figure 1

Rank importance of each compensation factor in determining owner compensation.	Size of Firm								Total	
	2 to 19 Lawyers		20 to 49 Lawyers		50 to 99 Lawyers		100 or More Lawyers		Mean	Median
	Mean	Median	Mean	Median	Mean	Median	Mean	Median		
Business origination	3.4	3.0	2.9	2.0	2.4	2.0	2.1	1.0	3.0	2.0
Case responsibility	5.6	5.0	5.3	5.0	4.4	4.0	4.6	5.0	5.2	5.0
Client responsibility	6.0	6.0	5.0	5.0	4.2	4.0	3.7	3.0	5.3	5.0
Community involvement	10.3	11.0	10.8	11.0	10.7	11.0	10.6	11.0	10.5	11.0
Contribution to firm management	6.6	6.0	6.4	6.0	6.9	7.0	6.5	6.5	6.6	6.0
Cooperativeness	8.4	8.0	9.2	10.0	9.5	10.0	8.6	8.0	8.8	8.0
Legal expertise	6.2	6.0	6.5	7.0	6.8	7.0	6.5	7.0	6.4	6.0
Professional involvement	11.1	12.0	11.3	12.0	11.2	11.0	11.7	12.0	11.2	12.0
Relative ownership percentage	7.6	7.0	9.8	12.0	10.1	12.0	10.7	12.0	8.8	11.0
Seniority within firm	8.5	10.0	8.4	10.0	10.8	12.0	10.0	11.0	8.9	10.0
Seniority since first admitted to bar	11.7	13.0	10.9	12.5	12.1	13.0	12.4	13.0	11.6	13.0
Work done, hours recorded	6.0	5.0	5.2	4.0	5.8	5.5	5.4	5.0	5.7	5.0
Work done, personal fees billed	6.1	5.0	5.4	4.0	6.0	5.0	6.4	5.0	5.9	5.0
Work done, personal fees collected	3.3	2.0	2.5	1.0	2.6	2.0	4.1	3.0	3.1	2.0

Respondents ranked responses “1” for most important to “14” for least important.

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Marketing... *continued from page 3*

Differentiating *new* business origination is helpful in reducing the problems described above, when working attorney credit or billing attorney credit is being stretched to fit new business. Adding a new business origination factor, however, which is often complex in itself, establishes another layer of complexity to a compensation system. Exceptions to two or three year sunsets can be made for practices with contingency fees and those with intermittent collection patterns, such as probate. Differentiating between institutional clients and litigation practices can be more difficult. The exact approach to distinguish between new business origination and origination or billing attorney credits often depends, in part, on the firm's practice mix and relative practice diversity. The effectiveness of the solution not only depends on practice mix and practice diversity, but perhaps even more critically on the firm's mixture of rainmaker and lawyer personalities.

Marketing Efforts

Many believe that marketing efforts, not just dollars originated, can and should be measured. Relative to formulaic systems, this is a short discussion, since marketing efforts will be viewed subjectively. Relatively often, non-billable time devoted to marketing will be considered, but very seldom in a formulaic manner, where a calculation is used to derive a percentage, credit or dollar figure.

Examples of Formulas, Origination and Marketing

Following are eight examples of formulaic (objective) law firm systems. Each of these approaches considers marketing or origination on some level, or it can be argued that it does so. Each of these methods has been observed or applied in law firms and would be pronounced effective by some significant constituency.

1. Divide the Pie Equally

The equal division of net profits, often referred to as "dividing the pie equally," does not expressly consider marketing — nor does it expressly consider legal work performed, business managed, management of the firm or any other factor — except the "we are all in this equally" factor. While there are benefits to the approach, including ease of administration and promotion of a positive "all for one and one for all" attitude, it is not surprising that fewer and fewer profit pies are being divided equally in law firms.

2. Seniority-Based Lockstep

The seniority-based lockstep system is formulaic in application, and in its pure form does not consider marketing. As the name suggests, a seniority-based lockstep system generally rewards an individual's years as a partner or shareholder with the firm or — infrequently — rewards total years with the firm or years in practice.

"... seniority lockstep systems have tended to continue increasing individuals' compensation until they retire, which does not typically track with lawyer performance norms."

While marketing is not the equivalent of seniority, there often is some correlation. In many firms and in many careers, the individual's marketing effectiveness and results do increase with seniority. In general, lawyers do better at rainmaking and in other performance-based factors as they become more senior. In practice, however, most seniority-based systems

function as too blunt an instrument, failing, by definition, to differentiate between individual performance levels in origination, either within the same seniority tier or between tiers. In addition, historically, seniority lockstep systems have tended to continue increasing individuals' compensation until they retire, which does not typically track with lawyer performance norms.

3. Simple Division

In this system, working attorney collections are tracked by individual lawyer, typically throughout the partner group. This simple system assumes that individual collections are equal to business developed, and that partners trade collections for work developed and distributed to other partners.

Calculate:

Individual's collections divided by total partner collections x 100 = individual's percentage of the profits.

Example:

Partner A @ \$250,000 / Total Partners @ \$1,500,000
 Equals .167 X \$750,000 (assuming 50% net profit)
 Equals \$125,250 in total compensation

The strength and weakness of this system is its simplicity. It is more suitable for office-sharing firms, however, as it doesn't provide for teamwork, and is likely to result in bartering.

4. Simple Formula With Origination Pool

In this example, 25% of all net profits are allocated to an origination bonus pool. A calculation is made using reported origination collections by lawyer.

Example:

Partner A @ \$300,000 origination divided by total origination of all partners (\$1,500,000) = .20 X \$187,500

(origination bonus pool — equals 25% of assumed \$750,000 net profit). Equals Partner A bonus of \$37,500.

This system is still quite simple, but differentiates between origination and other performance factors. Origination collections must be tracked by partner, and at least eventually, the question of new versus older origination will likely surface. The origination pool requires reasonably good budgeting by the firm, and a funding mechanism. Note that this system is slightly more complex than the preceding one, at least on paper, but that a single additional layer of complexity may increase the number of implementation issues geometrically.

5. Weighting New Versus Existing Business Origination

This approach is a variation on the “sunset of new business” concept: credit for *new* business origination is greater than for *existing* origination. For example, each new client matter will be given a double credit or double weight for the first three years, after which the new business half of the credit is sunsetted and the origination reverts to a single-weight credit. The credit or compensation amounts can be derived by calculation, as in the preceding bonus pool example, but results in weighting toward new business, i.e., rewarding and incentivizing hunting for new business over farming of existing business. This system requires more complex tracking, but is achievable with most modern accounting systems.

6. Formulas Based on the Hale and Dorr Method

This well-known formulaic approach to law firm compensation was developed in the law firm of the same name. Examples of variations on the original theme are usually seen:

- Each dollar of revenue collected is divided into two components:

70% working attorney and 30% originating attorney; or

- Each dollar of revenue collected is divided into three components: 70% working attorney; 20% originating attorney; 10% billing attorney; or
- Each dollar of revenue collected is divided into four components: 60% working attorney; 20% originating attorney; 10% billing attorney; 10% responsible attorney.

“... rather than employ a cookie-cutter solution, a law firm’s compensation system must be tailored to meet the needs of the particular firm.”

The individual’s share is applied to firm profits available for distribution to derive actual individual compensation amounts.

7. Rolling Average

This system calculates origination by individual lawyer, but on a rolling-average basis — for example, the average of the last three years’ performance. This method can prevent wide swings up and down, and can be applied as a retrospective calculation for the concluding year, as in a retrospective bonus pool, or be applied prospectively, to calculate a portion of an individual’s base compensation or base compensation percentage for the upcoming year.

8. Rolling Weighted Average

The rolling average can be weighted, for example, by giving a double-weight for the most recent year, on an ongoing basis. This

increases the weight on most recent performance, while still helping to smooth out peaks and valleys of performance.

Rolling average and weighted rolling average methods can be more significant for practices, or for firms, having incidence of feast and famine workload swings, or a mixed contingency fee practice.

Conclusion

As the legal market becomes ever more competitive, stimulating and rewarding, marketing and origination has been increasing. Formulaic law firm compensation systems respond to this by seeking to convert marketing into some kind of currency, usually origination dollars or credits, and to convert the currency, through calculations, into individual compensation dollars.

An overview of measurement methods and a range of formulaic approaches to handle origination — some rather passively, others aggressively — have been described. None of these systems should be considered in a vacuum, or simplistically pounded into an existing compensation system without careful analysis and reflection. Often, in law firm compensation, an action has much more than an equal and opposite reaction.

These compensation system descriptions are not an endorsement, beyond recognition that the systems have been implemented effectively by law firms. In fact, rather than employ a cookie-cutter solution, a law firm’s compensation system must be tailored to meet the needs of the particular firm. More often than not, Altman Weil consultants recommend subjective, or mostly subjective, systems in law firms, rather than formulas. ♦

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