

The Principles of Partner Compensation



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By James D. Cotterman

Principal, Altman Weil, Inc.
jdcotterman@altmanweil.com
altmanweil.com/Cotterman

Introduction

Reality Check No. 1!

There is no one single right or best way to determine partner compensation. Every approach has both worked well and failed miserably in different contexts. And each has attracted and retained high-performing individuals at some firms, while driving those same high-performing individuals away elsewhere.

Reality Check No. 2!

Compensation decision-making is asymmetrical — very little upside when it's done well and catastrophic potential downside when it is done badly. How many times has your partner compensation committee been cheered and celebrated for the fine work they routinely do, compared to the amount of scathing criticism they receive for any single, small error in judgment? Doing the job well is expected; doing it poorly creates the risk that talented people will decamp to other firms.

Reality Check No. 3!

Compensation is an extrinsic motivator — i.e., a bribe. If you truly want to motivate someone to change or improve behaviors, find out what intrinsically motivates them, such as the work itself, achievement or recognition. Nevertheless, you still need to get compensation right because it is a “hygiene” factor — it must be done well to avoid dissatisfaction.¹

So, in fewer than 200 words, I have assaulted the conventional wisdom underlying much of what law firms do with partner compensation. What's a law firm to do?

Challenges to Good Compensation Decisions

First, let's consider the purpose of compensation programs. The programs exist to make consistently good compensation decisions. It may sound self-evident, but it is a critical truth that is often overlooked. The compensation program is a set of tools that facilitates decision-making.

Making consistently good compensation decisions has become fundamentally harder largely due to a broader and more diverse business model with sometimes marked differences in profit contribution from otherwise similar revenue-generating practices. Several elements affect the model and further challenge partner compensation decisions.



Boomer generation retirements:

This major demographic shift challenges historical hierarchy and forces a tricky navigation of paying for succession efforts to boomer and successor partners simultaneously.



Fundamental shifts in client engagement:

Clients now define what is valued and this requires specific measurable criteria to inform how the firm's performance contributes to those value propositions. The new metrics provide a fact-based competitive analysis of law firm offerings that complicates traditional origination.



Disruption from technological advances:

New technologies supplant traditional skills and require skill sets that have not been seriously considered for compensation purposes.



Growth: Historically achieved by hiring and training new law grads, growth is now often combined with or superseded by hiring laterals who bring clients with them to their new firms. Lateral compensation premiums distort the compensation market and put stress on internal pay equity considerations.

*"Fasten your seat belts; it's going to be a bumpy night!"*¹⁰ may best describe the journey that lies ahead.

Solutions

There Is No One "Right" Way

Two examples follow illustrating how different firms can have different priorities and critical success factors that affect their approach to compensation decisions.



A Metric-Driven Scenario

A law firm was wrestling with a compensation program that had been around for just under two decades. The program was an objective, metric-driven approach that they had modified several times over the intervening years. Each tweak addressed a particular concern at the time, but with each tweak the decision quality decreased and the complexity of the program increased. After review, our recommendations were short and simple. First, use the original program — it yielded good results and it was easy to understand and apply. Second, do not tweak the program again on your own without assessing the program against broader principles, which we discuss below.



A Culture-Driven Scenario

In another situation, an extremely stable law firm had a largely subjective compensation program. They had metrics — all the typical accounting system data. Those metrics explained much of the variability of the compensation decisions. But there was an atypically large variability in compensation decisions that could not be explained by the financial metrics. The key to understanding this firm was in its culture. This firm's culture was a true ethos of the partners. They believed in individual performance differences, but only up to a point. Our assessment was that their decisions fit their firm, even if they departed from profession norms. Our advice was focused on communication — individual feedback to each partner and group discussions about how the committee functioned and members worked through the data and assessments of the partners.

So are there any universal guidelines regarding compensation process and structure that can be applied?

Smartly crafted pay decisions are hard work. The traditional partnership ethos of collegiality and co-ownership suggest a flattening of the pay range; this is set against the risk of competitor poaching of high performers that may necessitate a greater spread. There are competing interests between those lawyers who primarily acquire clients and those who focus on practicing law — setting up the age-old debate regarding the relative value of each. Moreover, those competing interests appear across a broad profitability spectrum.

And, oddly enough, the challenges increase when a law firm has either very little or a great deal of money to distribute. At the low end of profitability there is insufficient currency to differentiate pay based on performance or to approach market pay levels for those partners who have significant market attractiveness. At the upper end of profitability, the human emotion — greed — tends to display its unpleasantness.

There are also lively and ongoing debates about the appropriateness of nearly every facet of a compensation program:

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A. The decision perspective: Should performance be evaluated prospectively, retrospectively or using a combination of both?
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B. The type of compensation system: Formulaic, subjective, lockstep or some combination?
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C. The process: What is the right amount and type of input and feedback?
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D. Transparency: Should the compensation system be open, closed or a hybrid?
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E. Who makes the decisions: A managing partner, governing bodies, a special compensation committee or a committee of the whole?
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F. If a compensation committee: How should it be constituted and chartered?

Yet none of this really matters except in the context of a particular firm's philosophy and culture and how each facet supports consistently well-made compensation decisions. We can probably all think of a number of law firms that achieve great success and some measure of harmony with each of the variables mentioned. Likewise, we can also point to instances where each has gone very wrong and failed. If there were truly "one right way" to do this, a profession as learned and well-read as law would have discovered it. There is no one right approach, which is why advising firms in this area is an interesting and challenging career.

A Fundamental Principle

There is a reliable foundation from which one can build a well-functioning compensation program that the author calls Pay Proportional to Performance®. Two research studies published in 2001 support this notion. 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 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).

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 program may or may not be the right structure for an organization to achieve that end.

Key Structural Elements

On top of this foundation are various key structural elements that frame compensation decisions. These include internal rationality, strategy linkage, culture alignment, market competition and effective communication. Let us take each in turn.

Internal Rationality: Pay decisions should reflect merit, looking at a broad array of efforts — economic and non-economic — that an individual contributes to a firm's success. However, do not forget the irrefutable underlying economic principle in professional services that there must be a baseline expectation of good results and fully utilized timekeepers at appropriate price points to ensure a healthy and profitable firm.

Consider this question: Would an independent observer looking at the totality of contributions, their relative importance, individuals' specific contributions and the corresponding pay decisions reasonably conclude that those who contributed more to the organization's success were remunerated proportionally more than others?

Strategy Linkage: Recognizing smart, informed risk-taking efforts and results appropriately requires a thoughtful and careful evaluation of how one advances the business. Strategy implementation requires individuals to invest significant time that often exceeds a single compensation decision cycle.

Consider these questions: 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?

Culture Alignment: The shared attitudes and values that define the environment of a firm vary in both importance and style. If they are important, then the compensation program should recognize how well individuals support their preferred environment.

Consider these questions: Are firm values and the desired work environment clearly communicated and embraced? Will a person's behavior affect compensation in an appropriate and meaningful way?

Market Competition: We have a free market where lawyers may move from firm to firm, go in-house or even change professions. Pay decisions are rarely the primary determinative factor in such moves, but they often tip the scale when combined with other factors. Moreover, pay can become a primary factor if the market differential is large enough for a long enough period. A firm with below-market profits faces a very definite risk of losing talented lawyers. Compensation decision-makers must consider this.

Consider these questions: Are the pay levels 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 effectively to manage the departure risk of stars and rising stars?

Is your firm's pay level competitive? ALA does a yearly Compensation and Benefits Survey that features base salary, benefits and total compensation data for 58 individual management positions, plus associate attorneys, legal assistants/paralegals, and legal secretary administrative assistants.



alanet.org/compsurvey

Effective Communication: Providing feedback is important in any program that has some measure of subjectivity. This is the context that ties together each of the previous elements with the process of gathering input and the rationale for the decision. It allows partners to “connect the dots.”

Without candid and constructive dialogue, 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 even positive compensation decisions may not be interpreted correctly by the recipient, particularly if the individual's expectations differed from the result.

Consider these questions: Are the communications candid and constructive? Are they bi-directional with partners providing input in advance of decisions and receiving feedback after decisions? During feedback, do you discuss how a decision was reached and demonstrate that you carefully considered partners' written materials and actively listened during their interviews? Do you tie together this year's decision and how to improve next year with their roles in advancing the firm's strategic interests and culture? Are the right people involved in that conversation? (Many firms fail here.)

Do these right, and firm leadership earns credibility and trust. Get it wrong and you not only risk losing that trust, but the partners' actions may stray from what you say is important toward what you demonstrate is important.

Performance Assessment

Over the years, as law firms have evolved, so have the methods to manage them and pay their partners. In a 1993 Altman Weil survey on law firm compensation methodology, law firms were almost evenly divided on prospective, retrospective or combined approaches to making the compensation decision. It was a relatively simpler time in which to make decisions. Two decades later, a combination of prospective and retrospective is the leading approach. This is consistent with a post-recession market that values immediate past performance for compensation purposes, coupled with the need to consider changing boomer contributions.

Yet, over that same period, the most important partner compensation criteria in law firms remained the same — the abilities to acquire, maintain and grow client representation (all elements of origination).

It is imperative that partners possess a keen and well-developed ability to attract profitable business opportunities consistent with the firm's strategic vision.

Emphasis added as this skill is absolutely essential!

The other economic contribution expected of all lawyers is personal productivity — fees collected from practicing law. Studies verify that consistently high revenue per timekeeper is essential to high economic performance. It is almost universally true that a lawyer with a large practice who provides significant work to their team and effectively cross-sells work for others in the firm is also personally very productive (as measured by fees collected for their own work).

Rank order of the value of these attributes can be broken down as follows. First are those lawyers who do it all exceedingly well. Next are those lawyers who are great at client acquisition — creating initial relationship and opportunity to get work. Following closely after are those lawyers who are great at minding the existing relationships (retention and growth). It is exceedingly rare for lawyers to be in these groups without also being productive individual practitioners. Finally, there are those lawyers who are not relationship-oriented but are gifted practitioners.

Listing them in this way roughly reflects the rarity of each. At the top are the fewest in number, with each additional group increasing in size as we work our way through the list. This is not to say that those at the end of the list are not valuable. It is a matter of proportional value and there can be overlap among the groups.



Lawyers who do it all exceedingly well



Lawyers who are great at client acquisition



Lawyers who are great at minding the existing relationships



Lawyers who are not relationship-oriented, but are gifted practitioners.

Beyond primary economic contributions, there is a significant amount of talk about the importance of collaborative behaviors in law firms. It is generally believed that clients want collaborative firms that team effectively and efficiently to address client matters. The importance law firms place on this is determined by how interdependent their practices truly are. A 2009 American Lawyer Media study indicated that individual performance drives 64 percent of compensation decision-making in law firms; in 2014 that factor increased to 71 percent. Clearly, the “walk” of compensation decisions is not proportionate to the “talk.” This reflects the influence that lateral free agency — with its emphasis on personal book of business — has had on the internal functioning of law firms.

Origination

Demonstrated business development ability is a critical requirement for a fully contributing partnerⁱⁱⁱ. Recognizing client acquisition, retention and growth is therefore the most important consideration in compensation decisions, yet many firms do not formally track this attribute. This often leaves compensation committees to sort out a realistic snapshot of how and why clients come, stay and give more business to the firm. Moreover, this task only gets more difficult as firms grow and the nature of the client relationships expand across time zones, offices, client business divisions and firm practice groups.

Recognizing and allocating origination is a common struggle within firms. In reality, it is a matter of finding answers to three questions:



Sometimes it is easier to start at the beginning, rather than litigate, or relitigate, within an existing framework that is not working.

The best approaches to recognizing origination usually incorporate some or all of the following attributes.

Shared Credits: Working together to pitch your firm's skills is a good thing. When those efforts result in success, recognize the entire team with origination credit. Allocate the credits using the proportionality of effort and contribution to the sales effort, erring on the side of generosity. When the efforts do not land additional work, recognition for the efforts can be reflected in the intangibles of marketing and firm promotion.

Broad Definition of Origination: Some firms evaluate client acquisition, retention and growth with a single very narrowly defined metric; others blend two or more metrics together, creating a broader definition of origination. The debate continues about how and why a new client gives the firm its business. As the boomer generation lawyers prepare to retire, the discussion more frequently focuses on who should receive credit for long-term clients and how to handle transition from one generation to the next. Understanding that this critical ability to acquire, retain and grow clients presents itself in a variety of ways may lead a firm to a better set of decisions.

Credit Duration: At the client level, credits should last for the duration of all matters opened during a period of maybe three to five years, then be phased down or reallocated based on the current contributions to the clients' retention and growth. Often these efforts focus on relationships and strategic guidance as opposed to specific case management. At the matter level, credits naturally last the duration of the matter. Deciding whether to open new matters should not be driven by reluctance to honestly assess who should get credit in the current situation. Matter-level credits generally do not require reallocation.

Protocols: Successfully navigating the origination labyrinth is best accomplished when the firm has a documented, consensus view as to what origination is and how it should be allocated. Protocols aid the day-to-day decisions about credits and aid the acculturation of laterals and promoted associates. Start with a series of vignettes that describe how a client got to the firm, why they remain and why new work is coming. Set out a fact pattern and then determine the fair allocation of credit. Then alter the fact pattern and determine how that alters the allocation or not. Do this across many different scenarios. Put the questionnaire in a survey tool and have each partner complete it. Score the results and discuss where consensus is lacking until you arrive at your firm's way of handling origination.

A word of warning: we often hear that younger partners expect to inherit a practice when older partners retire. This is a deadly attitude. The market is far too competitive to sit back and wait to become a beneficiary. Each partner must pursue a market presence and devote time to business development. Transition and succession of current relationships is a purposeful, multiyear activity that involves firm leadership, the elder partner, the successor partner(s) and the client. Take this for granted at your own peril.

Subjectivity

Many firms look beyond pure economic contribution and consider other factors such as work/service quality, management/leadership, marketing/firm promotion, development of oneself and others, fiscal stewardship, good corporate citizenship and the like. Make sure each subjective factor has a well-defined scoring system to ensure consistency and clarity. (A sample system is available from the author.)

Attempting to assess and reward intangible contributions generates the kind of polarizing passions more typically reserved for political and religious discussions. Some firms embrace a qualitative approach, while others flatly reject such notions. There will likely be significant change in this area as law firms and the markets they serve evolve over the next decade. Evolution of the business model will alter how firms operate and how compensation decisions are reached. Initially, rational judgment will be used to incorporate new factors. Later on, new metrics will augment or supplant the subjective elements.



Equity Theory and the Underproductive Partner

John Stacey Adams developed the Equity Theory in the 1960s. The equity theory in compensation states that compensation is an exchange of labor for pay and that there is an appropriate pay range for every job. This theory explains why underperforming partners are not rehabilitated by reductions in compensation. Underperforming partners, working under the equity theory, reduce performance to a level they believe appropriate to the reduced pay (the partners did not believe performance was low relative to pay before the reduction). If a compensation reduction is necessary, it should be made to recognize internal equity with others; not to correct the behavior or improve performance. That must be handled differently.

The Power of External Competitiveness and Firm Profitability

In addition to the basic goal of having compensation align clearly with contribution, research shows that the fairness of compensation is also judged by two other factors: perceptions of what other organizations pay for similar work and the employer company's profitability^{iv}.

The firm's profitability is important because it will affect the ease or difficulty a firm has in making compensation decisions that competitively align 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 pay at market levels. 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 market and the firm should not become too great for too long, as partners' tolerance is unlikely to last.

Regular Compensation Reviews

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 and 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.

Summary

Partner compensation has always been a challenge. First, it is a set of decisions typically made over a condensed two- or three-month period each year — so the decision-makers never have much opportunity to improve their process or skills. Another challenge comes from false premises that form the basis for many programs. And then there is the complex nature of the relationship between partners and their leadership (who are also their partners).

Today's market forces are making these decisions even more challenging. A profession steeped in precedent and slow to change is now confronted with a dynamic market in transition, and the pace of change is accelerating. Finally, throw in a hyper-competitive lateral market that undermines some of the fundamental principles of good compensation decision-making.

Equity in compensation decisions is important because it engenders trust in the credibility of firm leaders. 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.

There are no shortcuts to good compensation decision-making. Each firm has to put in the work to appropriately reward the behaviors and performance they as a partnership value most, and balance that against external forces of competition for talented lawyers and profitable client work. This article sets forth the principles of partner compensation. There are many additional topics that compensation committees will struggle with (many of which the author has addressed elsewhere^v). But it is important to begin with these fundamentals and return to them regularly to maintain a fair and effective compensation program in your law firm.



About the Author:

James D. Cotterman is a Principal of legal 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 him at jdcotterman@altmanweil.com or review his bio at altmanweil.com/Cotterman.



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Endnotes

- i. See Herzberg's Hygiene Motivation Theory. Also review Dan Pink's TED talk, *The Puzzle of Motivation*.
- ii. Bette Davis, as Margo Channing in *All About Eve*.
- iii. See the author's article, *Who Should Be a Partner in a Post-Recession Profession*, available at altmanweil.com.
- iv. *The Enthusiastic Employee*, Wharton School Publishing, 2005, p. 12.
- v. See following Bibliography of Resources.