Trends in Partner Compensation Systems in Law Firms

An increasingly competitive legal environment is resulting in changes in the way that law firms pay their partners.

In my experience there are three main types of partner compensation systems:

1) Equality/lockstep - Compensation is determined mainly by seniority. I've seen this system used by many small firms and some very large US and UK firms. The advantage is that it encourages partners to work as a team, while the disadvantage is that partners may not feel it's fair if other partners don't pull their weight yet are paid the same as high performers. This can lead to a lack of incentive for high performers, and creates a risk they may leave.

2) "Eat what you kill" – Compensation is determined mainly by personal production. This system is used by small and midsize firms. Objective systems like this focus just on the numbers, which makes it clear to all partners what the expectations are and is fairly simple to determine compensation as a result. The downside is that these objective systems also encourage partners to "game" the numbers to their own advantage. This can lead to breakdowns in team-building, where partners act as "lone wolves" and talk about "my clients", not firm clients.

3) Subjective Merit – Compensation is determined by subjective analysis supported by objective factors. It usually involves a compensation committee of 3 or 4 partners, and is used mainly by midsize and large firms. This system has the advantage of encouraging partners to operate at a higher level and get compensated accordingly. In addition, the subjective merit system may have an objective component as a starting point, but subjective analysis reduces the potential for "gaming" the system in a purely objective formula system.

Depending on the culture of the firm, any of the above systems may work effectively. However, my experience and research indicates that the most effective system for increasing profits is the subjective merit compensation system.

Compensation System Trends

One of the major trends I see is towards more "pay for performance" in law firms, with a particular emphasis on rainmaking results. Rainmakers are paid big bucks to switch firms, especially commercial lawyers who are able to command and move a large client base.

Compensation compression ratios (the $'s paid to the highest paid partners compared to the lowest paid partners) are increasing, as firms accommodate rainmakers at the top end of the pay scale.

Law firms are requiring an increasing minimum practice size to remain as an equity partner.

Non-equity partnerships are growing in popularity as firms attempt to maximize their leverage and equity partner compensation.

Large firm compensation systems are becoming more “corporate” in nature, as firms grow in size and scope internationally. The larger the firm, the more corporate the model. Managing partners and executive committees are wielding more power and are providing more input to the compensation of individual partners, who are becoming more like employees in large firms.

Managing partners and practice group managers are being compensated more for their management accomplishments. Some firms are compensating their managing partners using balanced scorecard techniques as one example of this trend. Law firms are trying to run like real businesses and are delegating more and more of the firm’s business functions to their management partners.

Many firms are requiring pre-retirement phase-downs in compensation and have established retirement policies at a set age eg. 65. There is some controversy here, however, given challenges to the legality of forced retirement. Firms are continuing to try to enforce these retirement policies in order to maintain increasing equity partnership leverage and profitability objectives.

There is a trend for senior partners with movable practices to change firms where they’ve spent their entire career after being forced out by national firm retirement age policies.

Most firms have fairly “open” compensation systems, where partners know what other partners are being paid. However, there is a trend towards less compensation transparency at larger firms, with power and information centralized within a few management partners. Compensation discussions can be too much of a time distraction for large firms.

More non-equity compensation arrangements are being used for hiring lateral partners and retaining good "up and comers" with long-term potential for building a practice.

Buy-in requirements are growing as firms grow and partner leverage increases.

The new generation of partners is demanding and receiving more flexibility eg. Part-time partner compensation and virtual office arrangements.

Compensation Criteria Trends

There is more emphasis on teamwork, and less emphasis on personal billable hours. This also ties in with growing recognition for the need to lever work, and the growth of alternative billing practices.

More firms are doing strategic plans in response to increasing competition, and this is leading to a need to recognize partners’ non-billable efforts in implementing strategic plans at the firm, practice group and individual partner levels. This also means more recognition of training, supervision, quality control, and various other non-billable tasks performed by partners.

More firms are recognizing client origination results, and firms are tracking client and matter origination more diligently. Sales skills are being taught to partners and associates.

More peer evaluation is happening, especially in larger firms. There is also more emphasis on client feedback, realization and profitability of partners' practices. More emphasis on cash in, and less on billings.

Compatibility with firm culture is becoming more important. Non-conformists with firm culture are punished, leaders are rewarded.

Summary

The key trend is toward more “corporate” compensation models, driven by competition and the corporate style of growth of large national and international firms. Compensation is driven more by the strategic goals of the firm, and partners who contribute to firm goals are compensated at higher levels as a result. There is more and more emphasis on pay for performance as well.

Compensation compression ratios are widening, as firms attempt to accommodate and retain the rainmakers in their firms. This has resulted in major dollars being spent to lure new rainmakers to the large firms. Business development is more and more highly prized, and rainmakers’ compensation is increasing significantly.

The danger of a very high compensation compression ratio is that you could end up like Finley Kumble a few years ago. They hired many rainmakers and paid them exorbitant dollars for their client originations without a sunset clause, and the whole firm came crashing down as a result. Several different factors were involved, but the extremely high compensation compression ratio was pointed to as a major factor in their demise.

Firms are also trying to encourage partners to lever more to others, and in the process institutionalize clients so that it is more difficult to move clients when partners are offered more money by other firms to lure them away. Buy-in requirements are rising as firms lever more and reduce the % of equity partners relative to non-equity partners and associates.

Large firms tend to favor subjective merit systems, while smaller firms tend to favor more objective systems. Large firms are increasingly profitable, and the gap is widening, so there may be some correlation/cause/effect in the use of subjective merit systems which leads to increased profitability.

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