



Partner Compensation: Creating a Performance-Boosting Scorecard

by August J. Aquila

TheRemsenGroup

727 Kirkwood Avenue - Atlanta, GA - 30316
404.885.9100 - www.TheRemsenGroup.com

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Until recently, times were good, very good indeed, for most law firms. Profitability increased year by year and the economy kept lawyers in the money. Under those circumstances, there was little need to discuss—let alone worry about—partner compensation. As the saying goes, "Cash is king."

Times have clearly changed. Today the central subject in many firms is what to do about partner compensation. Despite the talk, no one has yet developed the perfect compensation system, and it's unlikely that any one ever will. That, however, does not mean that there aren't better ways to determine compensation than the traditional methods of billable time and origination being used today.

What, Really, Is Compensation?

Law firm compensation systems often fail to differentiate between salary and profit distribution. The majority of firms pay out most of their earnings in monthly draws to the partners. In fact, asked what compensation means, the average law firm partner would reply, "It's my biweekly draw." In other words, partners don't tend to differentiate between base pay, profit allocation, pension contributions and other benefits and perquisites. That's not the way compensation is thought about in the business world.

Executive compensation in the corporate world is normally presented as "total compensation." This consists of base pay, short-term incentives (such as year-end and quarterly bonuses), long-term incentives (such as options, other deferred compensation and retirement benefits) and other benefits and perquisites (such as health, disability and life insurance).

Some firms claim that they pay according to what they consider to be "market" compensation. That is a nebulous term that fails to define whether the firm is comparing itself with a market performer or an underperformer. Moreover, unless the firm's financial performance is at or above market, it will have trouble paying "market" year after year.

What Is Fair Partner Compensation?

I've yet to meet a partner who felt that he or she was overpaid. Although that's a healthy attitude, it's not necessarily the reality. There are partners who, undoubtedly, are underpaid for their contributions to the firm and, of course, there are others who are grossly overpaid. The cold hard fact for many partners today is that they could not go into the marketplace and replace their current compensation. Nicholas J. Mastracchio, in his book *Mergers and Acquisitions of CPA Firms* (American Institute of Certified Public Accountants, 1988), says that a fair compensation (salary) for owners (if they sell their firms) is based on the following formula:

Owners' salaries = staff (i.e., associates) salaries x owners' billing rates / staff billing rates

Why couldn't this formula be used to set base salaries for law firm partners? Here's how it could work. In "Best Service Law Firm," the associates have an average salary of \$100,000 and an average billing rate of \$144 per hour. The partners have an average billing rate of \$225 per hour. Using the preceding equation, the partners in this firm would be paid \$156,250 in salary:

Partner salary = \$100,000 x \$225 / \$144 = \$156,250

Remaining income after base salaries were paid could then be paid out in bonuses or used for capital improvements. The strategic value of having such a compensation system is clear. Partners now have much more of their income at risk and, as such, will not only perform at a higher level, but also will help the firm achieve its strategic objectives. The questions that firms then struggle with are: (1) how should profits be distributed to the partners? and (2) what criteria should be used to determine profit allocation?

Building the "Near-Perfect" Compensation System

It is impossible for anyone else to answer those two questions for your law firm. The ultimate answer has to come from inside the firm, not from an outside consultant. Each firm needs to develop a system that works for it uniquely and helps achieve its strategic focus. Consider these key strategic points in building your compensation system:

- Compensation systems are self-funding unless the firm decides to borrow money from the bank to pay partners. Although this is not a very smart idea, I have seen firms do it.
- The compensation system should shape your firm's culture, rather than your culture shaping the compensation
- Compensation systems should be flexible. As your firm and the external environment change, so should the system.
- Ownership means putting your compensation at risk. Partners should realize that, as owners, their "compensation" is never guaranteed.
- Should be rewarded accordingly.
- Compensation should be tied to results. Efforts are important, but results count more.
- Owners need to be held accountable for their own actions, or the lack thereof.
- Compensation systems should measure multiple areas. A successful firm requires many different talents. It's like a sports team. Can you image a winning baseball team with all shortstops?
- Seniority means nothing when it comes to determining an individual's compensation. If that were the case, the oldest person in the firm would always make the most money.
- The system should be easy to understand and administer.
- The system should be retrospective. You want to pay the majority of the dollars at the end of the year, not throughout the year.
- Because compensation is a management tool, only firm leaders should set compensation-and no one else. Period.

What Should the System Achieve? Nine Goals

Every compensation system should have an endgame in sight. When you tie your system to achieving your firm's business success, you can aim for these nine goals:

1. Motivate partners to peak performance.
2. Modify partner behavior.
3. Retain the best partners and remove non-performers.
4. Attract desirable lateral hires.
5. Reward for results first and efforts second.
6. Drive business results and create value
7. Focus partners on their own results and compensation, not on that of other partners.
8. Promote associates to partner based on economic and not just professional criteria.
9. Create an equitable system over the long haul.

Where Do Current Compensation Systems Fall Short?

Few, if any, of the current compensation systems achieve the nine goals. Consider the common systems in turn.

Equal compensation. Frequently, small firms start with this system, which often works for a short period of time. It avoids partner conflicts around compensation in the beginning, or until one partner decides he or she is worth more than the others. Producers don't like this system because it ignores individual efforts. Since all partners share income equally, they should all be focused on making the pie larger. What happens, however, when a firm brings in a new partner? Does the junior partner also share equally?

Lock-step. Many firms have tried this approach, and many still use some modified version of it. It basically states that the longer you practice at the firm, the more valuable you become. Unfortunately, there is no correlation between value and tenure. This system encourages partners to retire on the job.

Pure formula . The attraction to this system has been its so-called objectivity. It is simple and easy to administer, and it can eliminate disagreements over pay (again, at least in the short term). The major problem is determining the "right" formula. One formula does not work for all partners in a firm. This approach causes partners to work the system to their personal benefit, not to the firm's benefit. It is also difficult to measure a partner's intangible contributions under this method.

Paper and pencil. Partners are given the total amount available for distribution in the coming year and are asked to allocate that amount among the firm's partners. In short, it gives each partner a say in the compensation of all the other partners. Firms that resist formulas may lean toward this approach. It usually works best in smaller firms. In larger groups, it is almost impossible for partners to evaluate the performances of one another.

One person decides. In those firms that function under the "benevolent dictator" system, the partners (for a variety of reasons) abdicate their input to one person in the firm. As long as this person keeps everyone happy, the system works. But no one ever really knows how his or her performance relates to pay.

Compensation committee. Most large firms have a compensation committee that determines partner compensation. A major question is: Who gets on the committee and why?

Shared overhead. This is not so much a compensation system as a pure economic business model. Overhead expenses are allocated to each partner, who essentially keeps what is left after paying her or his portion of the overhead. It's not conducive to creating a real firm.

What's Involved in a Performance-Based System?

Although a performance-based compensation system can achieve the nine compensation goals, no system, in and of itself, will solve problems that management does not choose to address. Consequently, management must decide what is important for the firm to achieve. Then it must assign specific goals to each partner-goals that, when accomplished, move the firm closer to achieving its strategic focus. Along with the basics of billable hours and collections, firms are using multiple alternative criteria, such as the following:

- Client satisfaction
- Employee (staff and associate) satisfaction

- Reduction in A/R and WIP days outstanding
- Realization
- Hours managed
- Development of a new practice area or group
- Process improvement
- Marketing
- Pro bono work
- Client attrition
- Collaboration efforts
- New matter development
- Firm management

Add whatever criteria you want to the list to improve partner performance in your firm. Then, the next step is to create the individual partner's scorecard. Under this method, partners do not compete with each other but with themselves. A win for one is not a loss for another. Regardless of the individual partner's specific criteria, the total possible points that any partner can achieve are always the same.

How does the system work? Here's an example. Partner A has five criteria to be measured against; the total of the five will be weighted 100 percent. Partner B has three criteria; their total will be weighted 100 percent. The total possible points for each partner will be the same, let's say, 500. Each criterion is rated from 1 to 5. At the beginning of the year, each partner knows what is considered a 1, 2, 3, 4 or 5 rating. A rating of 3 means the partner did what was expected, while a 1 indicates total underperformance and a 5 far exceeds expectations. To see how it works, review the partners' ratings in Figure 1 on page 5.

Partners A and B earned a total of 710 points (280 + 430). Taken in percentages, that means Partner A earned 39 percent and Partner B earned 61 percent. If the available bonus pool for these two partners were \$125,000, Partner A would receive \$48,750 and Partner B would receive \$76,250. This would be in addition to their base compensation.

Now, because both partners' goals are set at the beginning of the year, each knows what they need to accomplish to earn their bonuses. They remain focused on the areas that have been mutually identified.

This system takes time to develop and implement, but if you truly want to get your partners aligned with the strategic vision of the firm, this may be the best way to do it.

About the Author

August J. Aquila, PhD (aaquila@worldnet.att.net) is Managing Director of Business Development at American Express Tax and Business Services, Inc. He is a nationally known author, speaker and consultant to professional services firms. He is the author of four books, most recently *The Power of Optimism*, with Andy Dzurinko.

Figure 1: Partner Scorecard

Partner A's Rating

Criteria	Wgt.	Rate	Total Points
1. Billable Hours	25%	2	50
2. Research	30%	3	90
3. Client Satisfaction	10%	1	10
4. Associate Training	25%	4	100
5. Pro Bono	10%	3	30
	100%		280

Partner B's Rating

Criteria	Wgt.	Rate	Total Points
1. Client Satisfaction	20%	3	60
2. Business Development	30%	4	120
3. Firm Management	50%	5	250
	100%		430