Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

THE LAW FIRM OF THE FUTURE

Trends in Law Firm Compensation Systems

March 20, 2024

by

Uri Gutfreund
SVP and Managing Principal, Ames & Gough

John Remsen, Jr.
President, TheRemsenGroup

MPF WEBINAR

POWERED BY
TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

TheRemsenGroup.com

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

BIOGRAPHICAL PROFILE

Uri Gutfreund
Senior VP and Managing Director
Ames & Gough
New York, New York
201.430.5827 – ugutfreund@amesgough.com

Uri is Senior Vice President, Managing Principal at Ames & Gough, a leading national specialty insurance brokerage firm. He helps law firms navigate through the complexities of liability and health insurance policies. As a Registered Professional Liability Underwriter, he is a frequent speaker and writer on insurance and risk management issues for law firms. He is also the founder of The Managing Partner RoundTable™, The Legal Resource Group, and a faculty member of Lawline.com.

April 2023

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

BIOGRAPHICAL PROFILE

John Remsen, Jr.
President
TheRemsenGroup
Atlanta, Georgia
404.885.9100 – jremsen@theremsengroup.com

John is widely recognized as one of the country's leading authorities on law firm leadership, management, marketing and business development. Since 1997 TheRemsenGroup has consulted with more than 400 law firms and thousands of law firm leaders to help them develop and implement long-term strategic objectives to improve cohesiveness, profitability and sustainability.

John is a frequent speaker and author on law-firm leadership and marketing topics. He has spoken at national and regional conferences of the Legal Marketing Association, Association of Legal Administrators, American Bar Association, and numerous state and local bar associations. His articles have appeared in dozens of highly respected legal publications, including the *ABA Journal*, *Law Practice Management*, *Law Practice Today*, *Law360*, *Legal Management*, *Marketing for Lawyers*, *Marketing the Law Firm*, *Managing Partner*, *National Law Review* and *New York Law Journal.*

Since 1988, John has been an active member of the Legal Marketing Association, and he has served as President of LMA's Southeastern Chapter, Executive Editor of *Strategies* (LMA's newsletter) and a member of LMA's national Board of Directors. He is also an active member of the Association of Legal Administrators and a popular speaker at ALA meetings and conferences.

In 2002, John created The Managing Partner Forum, a highly acclaimed conference series and community for managing partners and law firm leaders. More than 1,500 firm leaders from 1,000 law firms from 43 states have participated in 29 conferences. In addition, John distributes *The MPF Weekly*, an electronic newsletter to more than 10,500 firm leaders throughout the US, Canada and 28 other countries.

John's influence was underscored when he was inducted as a Fellow of the College of Law Practice Management in 2013, in recognition of his 25 years of demonstrated expertise in law firm leadership and management. Founded in 1994, the College honors those who "inspire excellence and innovation in law practice management." Membership is by invitation only and includes just 200 individuals.

And the College was not alone: in 2016, John was recognized by LawDragon as one of the "Top 100 Consultants and Strategists" to the legal profession; and in 2017, John was recognized as one of the world's top "leaders and influencers" in the business of law by the Association of International Law Firm Networks.

A native of West Palm Beach, Florida, John holds an MBA from The University of Virginia (1985) and a bachelor's degree in Business Administration from the University of Florida (1980). Prior to enrolling in graduate school, John was Executive Director of The Florida Council of 100, an organization comprised of Florida's top CEOs and other business leaders.

April 2023

The MPF Webinar Series

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

The MPF Webinar Series: Building the Law Firm of the Future

Trends in Law Firm Compensation Systems

An MPF Webinar with Uri Gutfreund and John Remsen, Jr.

March 20, 2024 – 2:00-3:00pm ET

TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

AMES & GOUGH

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

Welcome

Uri Gutfreund
Senior Vice President and Managing Principal, Ames & Gough

John Remsen, Jr.
President and CEO, Managing Partner Forum
President, TheRemsenGroup

TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

AMES & GOUGH

© 2024, TheRemsenGroup

The MPF Webinar Series

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

UPCOMING PROGRAMS IN 2024

- **MPF Webinar Series** – Third Wednesday @ 2pm ET
- **The MPF 2024 Leadership Conference** – May 1-2, 2024, in Atlanta
- **The MPF Fall Symposium** – Empowering Women – October 8-9, 2024, in Chicago
- ***The MPF Weekly*** – Friday mornings
- **MPF Listserv** and Monthly **MPF Zoom Calls**
- MPF Website – www.ManagingPartnerForum.org

TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

AMES & GOUGH

The MPF Webinar Series

The MPF Webinar Series

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

Valuing the Contributions of Your Team Members

How to fairly value and compensate the
unique contributions of each member of the team?

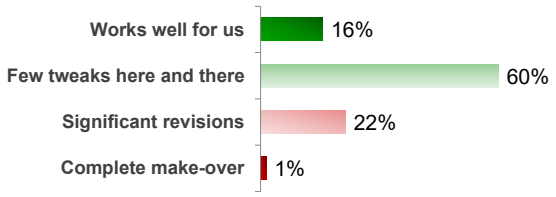
TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

AMES & GOUGH

© 2024, TheRemsenGroup

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

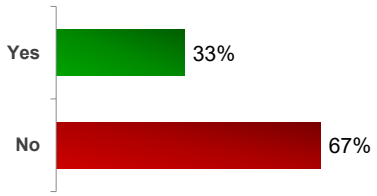
REGISTRANT QUESTION #1
Description that best describes your firm's current compensation system for lawyers?



TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

REGISTRANT QUESTION #2
Has your firm made any significant changes to its compensation model in the past five years?

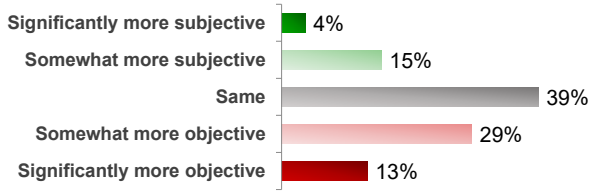


TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

© 2024, TheRemsenGroup

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

REGISTRANT QUESTION #3
Trending to more objective or subjective system over last five years?

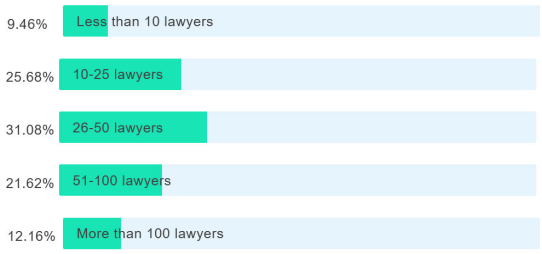


TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

AUDIENCE POLLING QUESTION

How many lawyers are with your firm?



TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

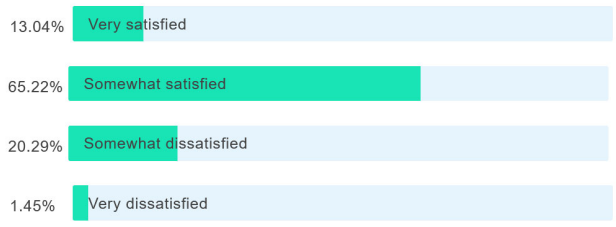
Ames & Gough

© 2024, TheRemsenGroup

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

AUDIENCE POLLING QUESTION

Generally, how satisfied are your firm's Equity Partners/Shareholders with your firm's current compensation system?



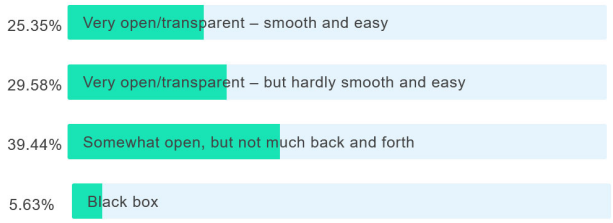
TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

Ames & Gough

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

AUDIENCE POLLING QUESTION

From the list below, which term best describes your firm's current compensation system?



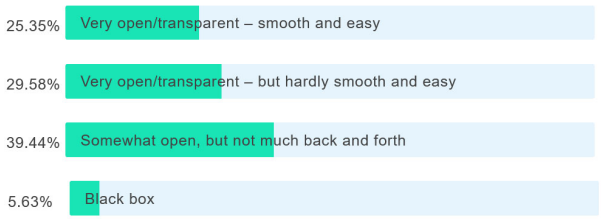
TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

Ames & Gough

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

AUDIENCE POLLING QUESTION

From the list below, which term best describes the process your firm uses to set compensation.



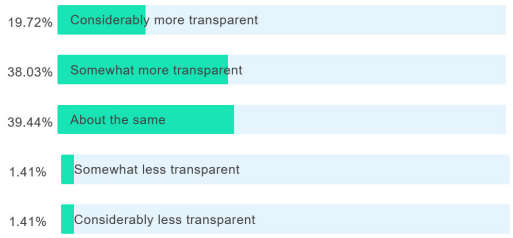
TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

Ames & Gough

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

AUDIENCE POLLING QUESTION

Which way has transparency been trending in the past five years?



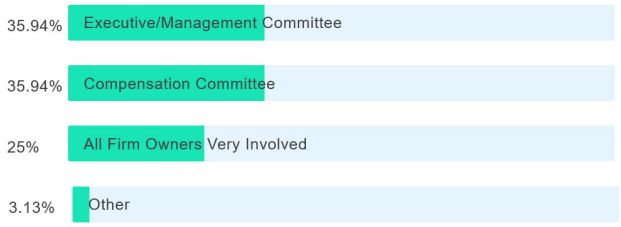
TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

AMES & GOUGH

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

AUDIENCE POLLING QUESTION

At what level within the organization does your firm set compensation for Equity Partners/Shareholders?



TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

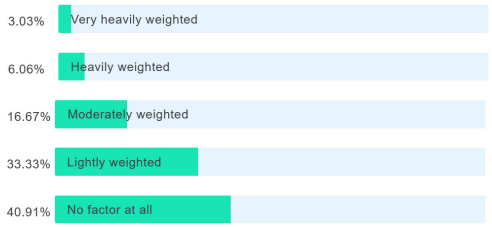
AMES & GOUGH

© 2024, TheRemsenGroup

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

AUDIENCE POLLING QUESTION

How much does your firm weigh SENIORITY when setting Partner/Shareholder compensation?



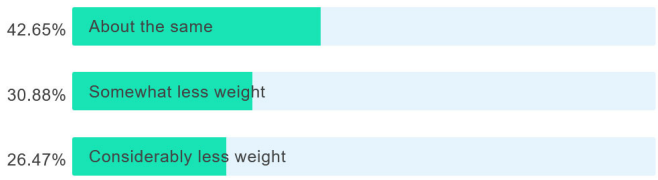
TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

Ames & Gough

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

AUDIENCE POLLING QUESTION

In which direction has the weight for SENIORITY been trending in the past five years?



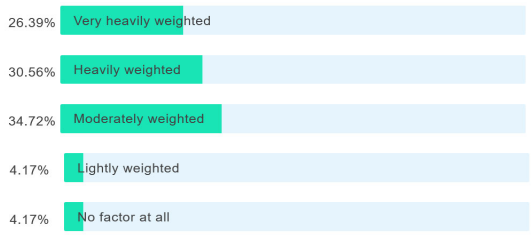
TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

Ames & Gough

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

AUDIENCE POLLING QUESTION

How much does your firm weigh COLLECTIONS when setting Partner/Shareholder compensation?



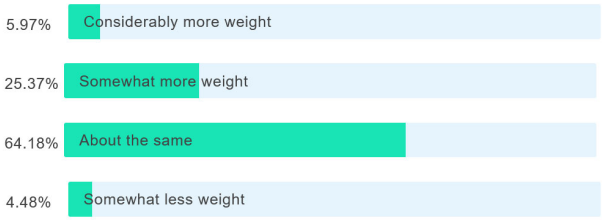
TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

Ames & Gough

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

AUDIENCE POLLING QUESTION

In which direction has the weight for COLLECTIONS been trending in the past five years?



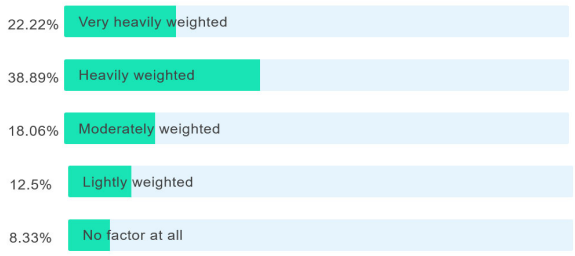
TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

Ames & Gough

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

AUDIENCE POLLING QUESTION

How much does your firm weigh ORIGINATION CREDIT when setting Partner/Shareholder compensation?



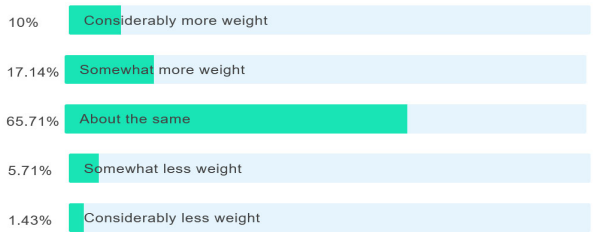
TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

Ames & Gough

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

AUDIENCE POLLING QUESTION

In which direction has the weight for ORIGINATION CREDIT been trending in the past five years?



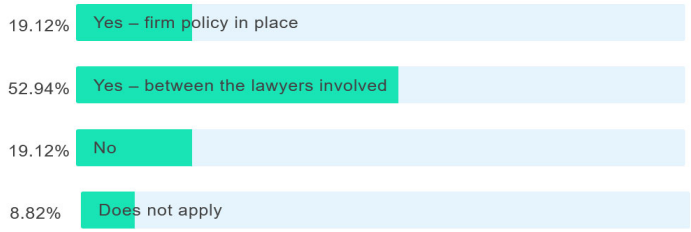
TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

Ames & Gough

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

AUDIENCE POLLING QUESTION

Does your firm encourage shared origination credit?



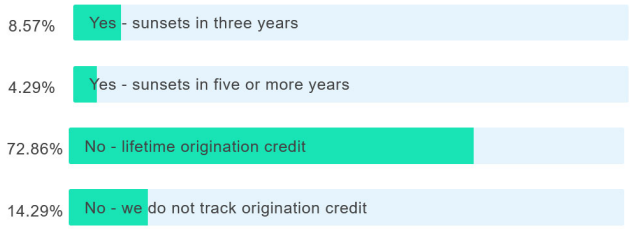
TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

AMES & GOUGH

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

AUDIENCE POLLING QUESTION

Does your firm "sunset" origination credit at the client level?



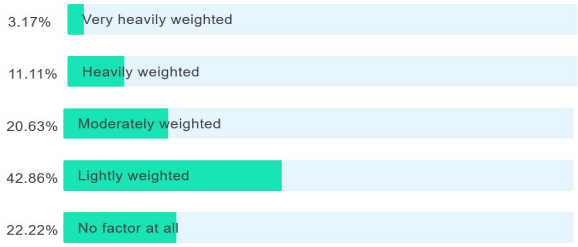
TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

AMES & GOUGH

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

AUDIENCE POLLING QUESTION

How much does your firm weigh FIRM-BUILDING CONTRIBUTIONS when setting Partner/Shareholder compensation?



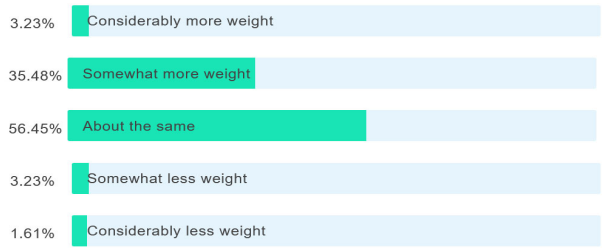
TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

Ames & Gough

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

AUDIENCE POLLING QUESTION

In which direction has the weight for FIRM-BUILDING CONTRIBUTIONS been trending in the past five years?



TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

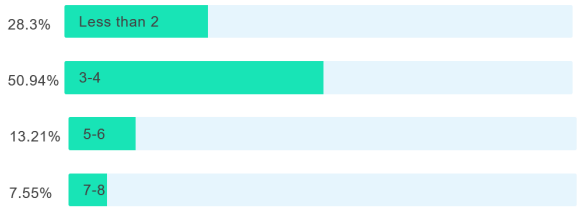
AMES & GOUGH

© 2024, TheRemsenGroup

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

AUDIENCE POLLING QUESTION

What is the multiple between the lowest and highest paid Equity Partner/Shareholder?



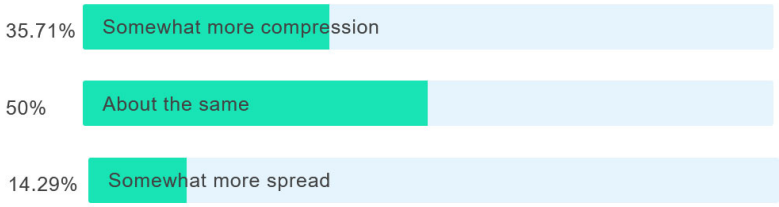
TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

Ames & Gough

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

AUDIENCE POLLING QUESTION

Is the spread trending up or down in the past five years?



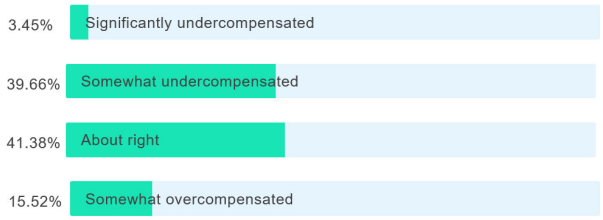
TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

Ames & Gough

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

AUDIENCE POLLING QUESTION

Do you believe that your firm's top performers are adequately compensated?



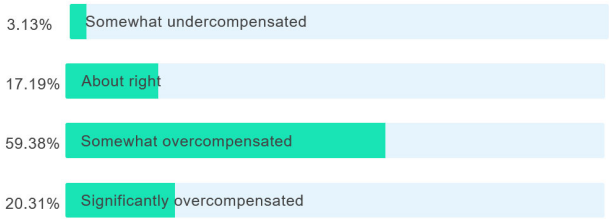
TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

Ames & Gough

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

AUDIENCE POLLING QUESTION

Do you believe that your firm's chronic underperformers are over-compensated?



TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

Ames & Gough

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

MPF OBSERVATIONS

- Compensation Systems Vary Widely
- There is No Perfect System
- Plan Should Align with Culture and Strategic Goals
- Reward Sharing, Teamwork, Firm First Behavior
- Fairness and Transparency Are Important
- Plan Should Naturally Evolve over Time
- Gradually Phase in Significant Changes
- Take Good Care of Your Top Performers

TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

Ames & Gough

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

REMINDERS

- **The MPF 2024 Leadership Conference** – May 1-2, 2024, in Atlanta
- Next MPF Webinar – **Managing Expenses to Improve Profitability** – April 17th @ 2:00pm ET
- On-Demand Recording, Handout Materials with Polling Results, Recap by 9Sail
- Your Feedback on Today's Session

TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

Ames & Gough

The MPF Webinar Series

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

CONTACT US

Uri Gutfreund
212.826.9744
ugutfreund@amesgough.com

John Remsen, Jr.
404.885.9100
jremsen@theremsengroup.com

TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

AMES & GOUGH

Managing Partner Forum®
ADVANCING THE BUSINESS OF LAW

The MPF Webinar Series: Building the Law Firm of the Future

Trends in Law Firm Compensation Systems

An MPF Webinar with Uri Gutfreund and John Remsen, Jr.

March 20, 2024 – 2:00-3:00pm ET

TheRemsenGroup
Smart Strategies for the Forward Thinking Law Firm

AMES & GOUGH

Partner Compensation

SYSTEMS USED IN PROFESSIONAL SERVICES FIRMS

BY MICHAEL J. ANDERSON • EDGE INTERNATIONAL

Before you overhaul of your firm's compensation system, consider this analysis of the strengths and weaknesses of the most common systems used in professional service firms. And keep in mind the basic truths about compensation.

In our work, we are exposed to a variety of methods used by professional services firms, particularly lawyers and accountants, to divide partnership profit. Compensation systems used We have found that almost all compensation systems fall into seven basic categories—or variations of these categories:

1. **Equal Partnership**
2. **Lock-Step**
3. **Modified Hale and Dorr**
4. **Simple Unit**
5. **50/50 Subjective-Objective**
6. **Team Building**
7. **Eat What You Kill**

BASIC TRUTHS ABOUT COMPENSATION SYSTEMS

If your firm is considering anything from a minor adjustment to a major overhaul of your compensation system there are some basic truths that you should keep in mind.

■ **There is no magic system that will satisfy all partners, meet all strategic goals and never need to be changed.** All professional service firms must realize that a compensation system is a living and breathing beast. It will need to change or adjust to meet the demands of changing times—either to satisfy partner concerns or to complement and reward compliance

with ever-changing firm goals. (And we all know that the only constant in professional life today is change.) Try as you might, some people will always think you are singling them out for a smaller piece of the pie.The best you can hope for is that most will view the system as relatively fair.

■ **A compensation system should be related to your firm's strategic goals.** For example, if you think that the mentoring of juniors is a worthwhile pursuit, then you had better have some form of reward for it in your compensation system or the message to your partners is that it is valueless and will only be done through their altruism and sense of teamwork.

Every type of compensation system has compelling reasons for adoption, or strengths, and often just as compelling reasons why it should *not* be adopted, or weaknesses. While a system might deal handily with partner concern A, it might have a reverse effect on partner concern B. For example, a system that rewards rainmakers might solve the concern of those partners most responsible for bringing in the work. If, however, the system does not reward the partners who take responsibility for those clients, you will offend a vital group of partners. You can bring in all the work in the world, but you will not improve your profitability if no one takes responsibility for the clients. The reverse is also true: The partners who are capable client managers will have nothing to do unless the rainmakers bring in the clients.

■ **A fair system can only be created when all those affected openly discuss the strengths and weaknesses of any proposed scheme.** This type of brainstorming session is the only way to get the issues out and dealt with in appropriately. In very large firms, each interest group in the partnership might send a representative to such a session, as opposed to asking every partner to attend and participate.

Of course, some firm leaders may think they can solve all of their compensation system problems and arguments by hiring a consultant who will meet with every partner and then create a report that will be acceptable to all. We relate this type of consulting to one of our favorite little stories:

> *They saw the consultant like a seagull flying in from afar. It circled their heads and dropped something white in their hands. They thought it was a report. Only after the seagull had disappeared from sight did they discover what it really was.*

■ **K.I.S.S. (Keep It Simple Stupid).** A compensation system that leaves most partners scratching their heads over the calculation of their individual compensation is doomed to fail. *You* may think it is straightforward, but be sure others agree with you.

"The impact of the most profitable partners leaving an equality firm can be devastating. Eventually only the poorer performing partners remain, profitability declines and the partnership dissolves."

THE SEVEN BASIC COMPENSATION PLANS

The following are the seven basic compensation plans in use by professional firms around the world, along with analysis of their strengths and weaknesses. Most firms employ a variation of one or another of these.

THE EQUAL PARTNERSHIP

This system is typically used only by smaller firms. Basically, all partners share in profits equally or equally within defined *groups* of partners. Here is a simple example. In a firm with eight partners that are divided into four senior partners and four junior partners, the senior partners equally share 60 percent of the firm's total profits (15 percent each), while junior partners equally share 40 percent of the firm's total profits (10 percent each). In a more complicated version, various levels of partners may share equally, but partners may move from one group to another each year—up or down, depending on their performance.

There is an underlying assumption that all partners are contributing to the overall firm performance equally, albeit in different ways. Some do it through their billable performance while others do it through non-billable contributions. It is usually when this assumption of equal contributions no longer appears to be true that the partnership starts to look for a fairer compensation system.

Strengths

In an equal partnership, the bigger the pie, the bigger a partner's share of profits. Therefore the paramount financial concern is firm profitability. Individual performance is

 © 2001 EDGE INTERNATIONAL

much less important than how well the firm does as a whole. As long as the firm does well, then the individual partners will do well. This allows for individuals to have performance swings—up years and down years—as long as overall the firm does well. Usually, performance is measured over a longer term basis, say three to five years, as opposed to limiting compensation criteria to a single year's performance.

Because individual performance is less important that overall firm performance, equal partnerships tend to be a great deal more collegial than partnerships that place more emphasis on individual numbers. This, in turn, allows partners to focus their competitive instincts externally rather than internally. The question shifts from "how *I* outperform my partners" to "how *we* outperform other firms".

Some firms choose the equality system because they find the whole pie splitting exercise—complete with finger pointing—to be repulsive. There is much to be said for avoiding the conflicts and internal bickering that develop in many firms at compensation time.

Another strength is that partners have a certain sense of security as to what their income will be in any given year or at any given time during that year. This, of course, reduces the amount of schizophrenia most partners feel when thinking about compensation. They don't fret over questions like "Are my numbers good enough?" or "Did Joe do better than me?" or "Will my non-billable efforts really be recognized?"

In such as system most partners work well together. They do not hoard either clients or files because their goal is to increase the total profit pie, not their own numbers.

This sounds pretty good, doesn't it? Unfortunately, there is a downside too.

Weaknesses

Equal partnerships face some very serious problems, mostly having to do with incentives or, more properly put, a *lack* of incentives. There is no financial reason or reward for the individual partner to push beyond normal partner performance levels. There is seldom much of an individual financial difference between the partner who works 12-hour days and the partner who plays golf most afternoons. There is no perceived or real value in working harder.

This lack of incentives can lead to resentment of those partners who are viewed as lazy or underachieving. If not promptly dealt with, this resentment can lead to a serious erosion of the collegiality that an equal partnership strives so hard to develop.

What's more, those partners who are more profitable, who put in more hours, bring in more clients or make valuable non-billable efforts will soon do more than merely resent those partners whom they perceive as doing less. They will leave to join firms where they feel their efforts are more appreciated and better rewarded in the financial sense. The impact of the most profitable partners leaving an equality firm can be devastating. Eventually only the poorer performing partners remain, profitability declines and the partnership dissolves because is no point in the staying together as a firm. The death knell is sounded because the firm is then only as good as its lowest common denominator or weakest link.

To avoid resentment among partners and maximize profitability, leaders of most modern firms will tell you that there must be at least some sense that individual efforts will be recognized and rewarded.

THE LOCK-STEP SYSTEM

The lock-step system is used by a fair number of firms that are organized in a traditional fashion. The basic concept is that each partner is rewarded an ever-increasing share of the firm's profits, based solely on seniority. The longer a partner remains with a firm, the more money the partner will make.

In a lock-step system, income can be divided exactly along seniority lines or, as with the equality compensation system, divided into levels. For example, the divisions might be senior partners (more than 15 years as a partner), middle partners (5 to 15 years as a partner) and junior partners (1 to 5 years as a partner).

Strengths

The greatest financial rewards in a lock-step compensation system go to those partners who have stayed with the firm for the longest time as a reward for their years of service to the firm. This obviously gives the firm, and probably the management of the firm, a great deal of stability. Few partners, once committed to a Lock Step system, would leave before

they had risen to the top of the compensation totem pole.

Partners also have a sense of security from knowing that their share of the profit pie is pre set. The only variable then becomes how big the pie will be. This security can help to create a more collegial atmosphere among the partners.

Like the equality system, lock-step encourages external competition rather than internal competition among partners because the only way to increase individual incomes is by making the overall pie bigger. With no divisive compensation meetings and no internal compensation competition to deal with, many of the partners will expend their energies trying to make the total profit pie bigger so that everyone makes more money. There is no financial advantage to file or client hoarding among the partners so they tend to work well together, again contributing to the collegial atmosphere.

Weaknesses

Like the equality system, lock-step does not directly reward individual contributions and initiatives. As a result, some partners will not expend extra effort when they know that all they need do is contribute at a normal rate to keep progressing along the compensation path.

This lack of financial incentives can have a great impact on a firm's profitability because, in some cases, it is actually a de-motivator. Why bother? In some firms the motto is, "You get what you pay for." Obviously, a lock-step firm cannot accept that kind of thinking if it is to succeed.

In many firms with a lock-step system, the younger partners feel a great deal of resentment by toward the senior partners. Often the attitude of these younger partners is, "What have you done for us lately?" Too often they see senior partners who have slowed down but still command the largest share of firm profits. As one partner said, "He has retired but has just failed to tell the rest of us." That kind of resentment cannot be good for any firm. Eventually it will harm profits and collegiality.

In lock-step firms where senior partners are perceived to be taking more than their appropriate share of profits, there will eventually be an exodus of the younger, hard working partners. They will move to firms that are prepared to recognize and reward their efforts. The result for the firm is lower profits at best, and disintegration at worst disintegration.

Some firms have tried to address this problem by increasing the percentage share of profits each year, but only to a certain level. After a certain point, the percentage starts to drop. For example, each partner may progress until reaching the age of 55 or 60, when their income slowly starts to drop as they prepare for their retirement at 65 or later. The thinking is that most partners reach the peak in terms of willingness to put in the hours and ability to generate profits somewhere between the ages of 45 and 55.

"The system places much more value on individual contributions and much less value on what the firm does overall. The clear assumption is that if everyone is motivated by the compensation system, the firm as a whole will do just fine."

Other firms have tried to address this same problem by setting a maximum number of "points" a partner can accumulate so that the most senior partners don't continue to amass ever-increasing shares of the firm's profits simply by growing older. Rather, they level off at a certain point so that many more of the partners become equal, at least in terms of compensation, at an earlier age.

David Maister, has expounded on the concept that "intolerant lock-step" is a viable way of distributing profits. He says that for a lock-step system to work, it must be *intolerant* of partners who do not meet enunciated expectations. If partners are allowed to under-perform, the system cannot succeed. He cites Skadden Arps as an example of a law firm that uses this method successfully.

MODIFIED HALE AND DORR SYSTEM

Back in the 1940s, the Boston law firm Hale and Dorr created what is regarded as the first incentive-based compensation system. The firm created three categories in which a partner could earn income: "Finder" (originator of the client), "Minder" (responsible for the client) and "Grinder" (the partner actually doing the work). Over the years, this system has been adopted by many professional service firms. The system has evolved, of course, but the basic premise remains the same.

An example of the Modified Hale and Dorr system might be:

- 10 percent of profits to the finders

 © 2001 EDGE INTERNATIONAL

- 20 percent of profits to the minders
- 60 percent of profits to the grinders
- 10 percent of profits to a discretionary pool, which is allocated at year's end to the partners who have shown exceptional performance.

These percentages can be adjusted each year to address issues that the firm determines are the most important for the coming year. As an illustration, a firm may choose to lower the finder category's percentage if it has plenty of good work coming in, and increase either or both of the minder and grinder categories so that people will focus on getting the work *done*. The following year the focus may shift and percentages can be adjusted to reflect those changes. This makes the system adaptable and flexible.

Strengths

This modified Hale and Dorr system is much better at rewarding the contributions of the individual partners than the equality or lock-step systems. The system places much more value on individual contributions and much less value on what the firm does overall. The clear assumption is that if everyone is motivated by the compensation system, the firm as a whole will do just fine.

Partners knows exactly what they have to do if they wish to increase their income. Many partners prefer such a system because it allows them to become the masters of their own financial destiny, either higher or lower depending on personal goals. For example, this system allows the partner who wants to spend more time with his children while they are growing up to slow down for a few years. He may do so and be assured that while his income may be less, his decision should not affect his partners and they should not resent him. In a few years, the same partner may realize that the best thing for him is to bear down and generate more income for his children's college education and for his own retirement. This system allows that kind of increase or decrease in efforts and contributions because it only rewards success and hard work.

Under this system there is much less bitterness toward a partner who is perceived to be making less of a contribution to firm profitability because when they contribute less, they receive less. Of course a partner who performs well below normal expectations will still have problems. This person may, in fact, be asked to shape up or ship out. Tolerance will only go so far.

Seniority has no direct value in compensation under the modified Hale and Dorr system, though a more senior partner would probably bill at a higher rate and therefore command a larger percentage of the grinder share of the profits when doing the same amount of work as a younger partner.

An objective system such as this greatly reduces the amount of pie splitting animosity that can develop under other systems. Partners have a good idea of what they will earn by applying the formula to their statistics at any time during the fiscal year. The only variable is the discretionary pool. However, because the pool is relatively small and the outstanding contributions are usually quite obvious to all, few arguments and hostility result.

Weaknesses

The modified Hale and Dorr system does a good job of taking care of the billable time rewards. Unfortunately, no rewards are built in for non-billable time, except perhaps through the bonus pool (and that is not the purpose of such a pool). If *all* partners equally share *all* the non-billable activities required in a professional service firm, then there would be no problem with this type of compensation system. However, most professional service firms do not equally divide responsibility for firm management, training or mentoring of juniors, practice group leadership, recruiting or committee work. So where is the motivation to use time for these important aspects of running a profitable firm?

Given the choice, partners will always opt for the billable work ahead of the non-billable work. As a result, this type of system can create more a firm of individuals rather than a firm of team mates.This is *not* a contributor to firm collegiality. In fact, often the opposite is the result. Partners become so concerned with their personal numbers and income, little time or effort gets expended on the type of activities that build teams and collegiality.

In addition, because partners are paid only for their production, many make the mistake of hoarding clients and work. Their thinking is that 60 percent as the grinder is a lot more that 10 percent as the finder. This can lead to resent-

ment by the other partners, and to liability risks when a partners perform work in areas in which they are not proficient. It is demoralizing as well to the juniors who are not getting enough work—or enough quality work.

THE SIMPLE UNIT FORMULA

The simple unit formula is designed to reward seniority, production, client generation and non-billable activities, using a relatively straightforward and totally objective calculation. A typical formula might be that each partner receives:

- one unit/point for each year with the firm
- one unit/point for $x of production (fees billed or fees received)
- one unit/point for $2x of client generation.

The non-billable units/points are awarded on the basis that the total available number of units/points is three times the number of partners. Then those available units/points are allocated on a pro rata basis for non-billable time recorded. Needless to say, when all of the units/points have been allocated they are converted to percentages and then applied to the net firm profit for the fiscal year to create each partner's individual income.

This system is not unlike the modified Hale and Dorr system in that it mainly rewards production in an objective manner. The biggest differences are that the simple unit formula also rewards longevity with the firm as well as some non-billable efforts.

Strengths

Simplicity is a key attribute of the simple unit formula. It is a straightforward calculation that most partners can readily understand and compute. And that is good! Remember the last truth at the beginning of this paper—K.I.S.S. (Keep It Simple Stupid).

The rewards under this system are for actual contributions in that it is a totally objective formula. Unlike most other objective compensation systems, however, the simple unit formula also takes into account seniority and non-billable time, at least to some degree.

Because production is at the heart of this scheme, there is less bitterness towards those partners who may be considered as under-producers or low profit contributors. These partners' rewards will be less when their production is lower.

Probably the greatest strength of the simple unit formula is that it lives up to its name. It is simple! Every partner knows exactly what they have to do to earn the income that they desire and they know at what level all of the factors are weighted.

"Unlike most other objective compensation systems, however, the simple unit formula also takes into account seniority and non-billable time, at least to some degree."

Weaknesses

The major drawbacks of the simple unit formula is that it can promote the hoarding of clients and files. Individual partners want to make their numbers and on a personal income level, there is little value in delegating work or clients. Obviously, a system that encourages hoarding results in less collegiality and the competitive focus can become internal rather than external.

The units/points awarded for seniority can cause some animosity among the younger partners as well. This may well become a serious impediment to lateral hiring since the new partners would start at zero points/units in the seniority factor compared to peers in the same firm.

THE 50/50 SUBJECTIVE/OBJECTIVE SYSTEM

The 50/50 subjective/objective system attempts to overcome the problems associated with systems that are too objective or too subjective. It recognizes that both types of criteria are valuable to the firm as a whole.

The objective part of the scheme is that 40 percent of partner income is based on actual billings or receipts, while 10 percent of income is based on actual client generation statistics. Please note that these percentages are not etched in stone and can be varied according to a firm's vision of what compensation should reward and what weight it wishes to give the individual criteria within its compensation system.

The subjective portion of the system is based on the perception of all of the partners of two other criteria. Ten

 © 2001 EDGE INTERNATIONAL

percent of the subjective portion is based on the perception of a partner's client handling abilities and 40 percent is based on the perception of all other criteria. Again, these percentages can be varied to reflect a firm's goals.

In large firms where partners may not have enough knowledge to accurately rate some of their fellow partners in the subjective criteria, some firms have opted to leave that part of the plan in the hands of the specific departments or practice groups.

Strengths

With a large portion (40 percent) of the subjective portion of this system being allocated to almost any strength a partner brings to the table, there is usually a great deal less animosity and more collegiality within a department, practice group and firm. This purposely undefined share of income can be used to reward unusual non-billable efforts, firm management, training of juniors, mentoring, being a team player, attempts at client generation that do not materialize immediately, or for being a nice person and an overall asset to the partnership.

This same 40 percent also can be used negatively. Awarding a low percentage can send a message to a partners who are not perceived as positive a contributors to the overall firm—even though they may have very good *objective* numbers. It is in a partner's best interest to get along, because 40 percent of a partner's income will be based on the his or her partners' perceptions of overall contribution to the department, practice group or firm. Negative things that may be taken into account and thereby adversely effect a partner's income are: file or client hoarding, being too demanding of staff and juniors, not contributing to firm initiatives, not complying with firm policies, not taking the time to properly train juniors, or just being an all-around pain.

Many firms and partners like this type of system because it allows for individual partner input into compensation through the subjective portion of the plan. As mentioned, some large firms leave this portion of the calculation to the department or practice group—the people in the best position to evaluate another partner's overall subjective contribution.

For those partners who demand that compensation be tied to actual performance, one half of remuneration is based solely on the objective numbers for billings/receipts and client generation. Under this system, the objective factors are recognized more than in some of the other plans but less than in schemes that are more "eat what you kill."

In that partners allocate 40 percent of the subjective portion of income, the system can serve as a form of partner evaluation. This is especially true when an anonymous report outlines the considerations that the partners took into account when allocating the subjective share of the plan.

The subjective part of the system should also go a long way to overcoming the problem some firms face with file and client hoarding.

Weaknesses

The partners who dislike this system say that it does not provide a good enough idea of what it takes to make personal income goals. In addition, others argue against the subjective portion as being too "touchy-feely." They want a more objective scheme that ties bigger rewards to actual production.

There is the chance that some animosity may develop over the allocation of the subjective portion. The "Who do they think they are telling *me* what to do" syndrome can set in and become divisive if compensation decisions are not properly and positively conveyed to every partner.

There can also be less collegiality some level of animosity aimed at the partners who do not meet expectations on the objective side of the equation because they may have been able to overcome that shortfall with the subjective criteria.

Perhaps the biggest argument against this compensation system is that, if not properly explained and implemented, the subjective criteria might be seen to being open to manipulation to some degree when this facet of the scheme is not backed up by data, in some form or other like a partner peer evaluation system.

TEAM-BUILDING SYSTEM

This is the ultimate team system of compensation. Individual contributions are given little consideration while firm profitability and practice group or department performances are paramount. It is diametrically opposite any form of an eat-what-you-kill system.

The formula for the team-building system bases 50 percent of a partner's compensation solely on how well the firm

does financially. Another 40 percent is based on a practice group or department's financial performance, and the remaining 10 percent is based on the individual partner's performance. These percentages can be varied to suit a particular firm's vision of what the weighting should be for each of the three areas.

Strengths

Simplicity may be the greatest strength of this system. What could be easier than just focusing on the firm and practice group or department doing well?

There is little pie splitting animosity because the system is totally objective and it downplays the role of the individual. All partners in a group or department will sink or swim based on their collective efforts.

The concept of putting "the team" ahead of the individual is a powerful way to promote firm goals. When everyone pulls together we all succeed to the highest levels. And, again, the competitive focus is external rather than internal.

Cooperation and collegiality at the group and firm levels are the cornerstones of a team-building system. This requires a partnership of individuals who are comfortable with one another, who have faith in one another to always do what is best for the team—to willingly waive individualistic tendencies when they conflict with the goals of the team.

Firms using the team approach seldom have file and client hoarding problems. Delegation is usually at a high level because it is in everyone's best interests to push work to the lowest competent level. This provides better value to clients, training for juniors, challenges in professional development and greater job satisfaction all around. In turn, those results have a positive effect on firm profitability, thereby perpetuating the system of teamwork. There is also greater cooperation between departments and practice groups because that, too, can help improve both group and firm profitability.

Weaknesses

Some partners may feel that there is a lack of recognition for seniority and experience. Unless there are levels of partners within the system, all partners would earn about the same amount. The only variable would be the relatively small percentage allocated base on individual production.

Some animosity may develop toward partners who are perceived as being the weak links in a department or practice group. That can also be a strength if a firm acts on the weak links by setting minimum standards for all partners—standards that do not tolerate lengthy periods of underachievement.

The individual large contributor may well leave in search of a firm that will reward individual efforts more highly. In fact, some argue that this system promotes a "lowest common denominator" approach. In other words, partners don't make enough of an effort because they don't see the direct rewards of doing so and don't feel they need to perform at a level above some of their partners.

"Before you can develop a successful, comprehensive compensation system you must have a very clear and agreed to credo as to what makes your firm tick."

EAT-WHAT-YOU-KILL SYSTEM

By contrast to the team-building system, the eat-what-you-kill system solely rewards individual efforts, with no recognition for anything beyond personal production.

One form of this type of system charges each partner a share of firm overhead, but each partner pays the salary of his or her secretary or assistant. Also, individual marketing, continuing education, personal technology and memberships costs are the responsibility of the individual partner. The time of juniors is "purchased" from the firm at set rates but charged out to clients at whatever billing rate the partner thinks is appropriate. Partners can also sell an interest in a particular file to another partner at a negotiated rate. (Typically, the client originating partner will get 10 percent of whatever is billed by the other partner.) Having dealt with all of the costs, the partner then gets to keep 100 percent of all receipts.

Strengths

Every partner has total responsibility for his or her income and clients—and partners know exactly what they must do to achieve the income levels they desire. There can be no blaming anyone else. The system provides incentives at various levels. First, the partners will want to bring in business

 © 2001 EDGE INTERNATIONAL

for others because they get a percentage of the billing when they "sell" the file to another partner or when they get a junior to manage the file. There is also an incentive for hiring and retaining only profitable, hard working juniors so that they can maximize their own incomes. There strong motivation for partners to collect their receivables because it is their own money. Lastly, the firm will maintain tight controls on spending because partners will not tolerate too large an overhead allocation.

There is no pie splitting animosity because there is no pie splitting. Everything is dealt with at an individual level.

Weaknesses

Probably the greatest weakness is that, in most cases, there is a total lack of responsibility for managing the entity. Because no one gets recognition for non-billable time spent there is often a void when it comes to firm management, training of juniors, firm marketing or human resources. Eventually, that must lead to major problems and possible disbanding of the firm.

The system creates no need for collegiality other than as a method to market other partners for work for their clients. Often partners don't even talk to their colleagues unless they have a financial or personal reason to do so. That, in turn, spreads throughout the firm, creating a very difficult environment for most staff, juniors and even some partners to work in.

Some firms using this system have problems with the work-sharing aspects. Some partners may choose to not work for another partner's clients for myriad reasons, leaving the originating partner to fend for him or herself in an area in which they may lack proficiency.

There is a definite hoarding of files and clients—that is what the system is all about. Sometimes this is to the detriment of the client. There are few "common good" factors at work because the individual good is paramount.

There is also little or no training of juniors because it is almost valueless under this system. Juniors find themselves in a sink or swim situation right from the start.

CONCLUSIONS

Are you wondering which, if any, of these systems would work best for your firm? As a starting point, you might try answering the question, "What do we value most?" Before you can develop a successful, comprehensive compensation system you must have a very clear and *agreed* credo as to what makes your firm tick—and a clear understanding of why this is the case.

Before exploring change, you must also gain a true reading of what your partners do and *do not* want in a compensation system. It can be very helpful to ask an outsider, someone with no hidden agenda or compensation baggage, to facilitate a brainstorming session among the people most affected: the partners. You may be surprised how agreeable your partners are once they have made their points of view known and considered the points of view of their colleagues.

No matter which compensation system you choose, remember these basic truths:

- There is no "magic" system.
- Compensation can not be legislated.
- Some of your partners will not like whatever you decide, no matter what it is.
- Relate the compensation system to the firm's strategic goals wherever possible.
- Try to get an understanding among your partners of the need and value for rainmakers, client minders and grinders. They need each other to be successful.
- Directly involve the people most effected: your partners.
- K.I.S.S.—Keep It Simple Stupid.

Michael Anderson has spent more than 25 years in and around professional firms throughout Canada (Toronto, Edmonton and Vancouver). Additionally, he has been a consultant to firms throughout North America since 1987. During that time he has been involved in every facet of firm management, marketing, administration, governance, partner compensation and strategic planning.

EDGE INTERNATIONAL

NAVIGATING THE COMPENSATION MAZE: SIX MAIN SYSTEMS, SIXTEEN VARIATIONS, AND SEVEN STEPS TO SUCCESS

By Nick Jarrett-Kerr | May 3, 2020

The last twenty years or so has seen considerable debate about the most suitable method of compensating and rewarding professional service firm partners and members. The traditional practice model of a professional service firm has long been the partnership model, a model that has also for some years developed into a partnership/corporation hybrid in which the partnership model of compensation has remained dominant. Over the last decade or so, more and more professional service firms have morphed into corporate models and this has introduced complexities to the various compensation models in use In traditional professional service firm models, the individualistic Eat What You Kill (EWYK) model is seen as one extreme of the spectrum, whilst the purer forms of equal-sharing lockstep schemes are viewed as being at the opposite end of the same spectrum. In truth, the use of models at both opposing ends of the spectrum have largely become rare. Many firms have constructed arrangements which try to meld the ethos of true partnership with something that encourages a hard-working in which individuals can be rewarded on a performance related basis

In this paper, I attempt to review the development of the more recent and bewildering trends in partner compensation in relation to the six main historical compensation systems. This includes a review of the adaptation and cannibalisation of the different systems, usually based at least in part on the firm's history and in part on current profit drivers and imperatives. In a separate paper, I review the main methods of reviewing and assessing partner contribution.

THE SIX MAIN COMPENSATION SYSTEMS IN PROFESSIONAL SERVICE FIRMS

There is no single system that has suited every professional service firm in the past and – as firms move towards greater degrees of corporate structures – there are likely to be many systems that attempt to incorporate or hybridise the best of the "Big Six" whilst

attempting to avoid the drawbacks.

SYSTEM ONE: PERFORMANCE RELATED (OR 'SUBJECTIVE-BASED') COMPENSATION

There is a discernible global trend away from both pure lockstep and the more individual and statistics-based systems such as Eat-What-You-Kill and Formulaic systems. Approximately 70% of U.S. and Canadian law firms primarily base their partner compensation on subjective criteria.[1] In accountancy 5% of US firms with 8+ partners use a compensation committee to allocate income vs. 15% using formulas[2]. The trend at both ends of the spectrum is towards a more performance related system relying on qualitative or 'subjective' assessments. The exact make-up and structure of so called subjective-based systems will vary enormously. Firms moving towards performance related systems will usually keep some vestiges of their historical or formula-based systems and many provide some certainty and security for their partners by fixing base salary or compensation tiers for their partners.

Some large international firms have moved onto compensation and rewards systems which are wholly performance based. Such firms often have as many as nine to twelve bands and partners are allocated into bands on an assessment of the sustained value which they have brought to the firm. In other words, the firm tries to look not just at one year's performance but for long term contribution. Some such firms will look two years back and one year forward to arrive at a view.

There are many examples of such firms worldwide. Typically, the firm will place partners in one of about eight or nine bands. A former partner of a UK-based international firm recently told us somewhat cynically that the top band is designed to ensure that a very small number of 'power partners' get more than $1 million per annum. The bottom band is an entry level band. In most firms with a system like this, the bands themselves are arranged so as to have significant gaps between bands – $100,000 or more is a popular band interval and there are often band intervals of up to $200,000.

Structurally, the firm will – as with performance criteria – tend to fix the highest and lowest bands first. The highest band will represent what the firm feels it must pay (assuming it is affordable) to the firm's star performer or performers, whilst the lowest band will represent a fair market package for an incoming equity partner. The other bands will be arranged with suitable intervening gaps between top and bottom.

Although this methodology can theoretically lead to huge uncertainty (as partners have no assurance or guarantee of what band they might be in next year), firms will often provide that partners can move up no more than two bands in any one year and have the certainty of knowing that they can only be demoted by one band in any one year. We have also seen some partnership provisions which provide for almost automatic expulsion if a partner is demoted more than once in a reasonable period of time.

The point should be clear by now that movement either wholly or in part onto performance related (or subjective-based) compensation should not be attempted until and unless all the partners are crystal clear as to what the firm expects its partners to do and how it needs them to behave. However small the firm decides the performance related part of the overall compensation should be and whatever the balance between client work production and other more 'subjective' areas, the firm has to decide the areas in which it wants its partners to perform as well as the criteria for success – those behaviours and outcomes which the firm will value and reward them. In addition, it has to form a view as to how the 'subjective' factors are going to be assessed, scored or judged.

SYSTEM TWO: FORMULA SYSTEMS

A formula system requires the firm to gather information such as billable hours recorded and billed, new business generation (originations), and collections, and then enter the data into an allocation formula which then spews out the compensation distribution. Many partners assume that most large firms – particularly in the USA – operate on such a highly objective, pure formulaic system but by my observation, however, only about 10% of large firms use a strict formula. Roughly one-third of firms have a system that at least in part is subjectively determined or moderated by a compensation committee based on consideration of data, interviews with partners, recommendations by firm leaders and similar inputs. At the other end of the spectrum, I estimate that only about 5% of firms use a pure lockstep system where profits are evenly divided among partners or where seniority is the sole determinant of compensation, but another 10% have a modified lockstep system where the seniority-based rise up the compensation ladder may be affected by performance factors. The remainder (about 40%) is some combination of two or more of these factors, most frequently an objective system that can be modified by subjective input.

EAT WHAT YOU KILL (EWYK)

Typically, in a EWYK-based system, performance as a practicing professional is objectively measured by a combination of originations and work performed. Although this approach is usually modified to include a few other performance criteria besides only billing, it still means that the professionals in the firm that produce are rewarded commensurately, while those that don't are penalized. The advantages of this system are that the firm can pay the premium salaries that the very top talent demands, and that the system self corrects for professionals that want to reduce workload, perhaps for lifestyle reasons. For middle sized and emerging firms, a highly incentivized system such as this may be the only way to attract top talent.

Under the extreme form of this system each partner bears a share of firm overhead, but pays the salary of his or her secretary or assistant. Also, individual marketing, continuing education, personal technology and memberships costs are the responsibility of the individual partner. The time of juniors is purchased from the firm at set rates but charged out to clients at whatever billing rate the partner thinks is appropriate. Partners can also sell an interest in a particular file to another partner at a negotiated rate. (Typically, the client originating partner will get 10 percent of whatever is billed by the other partner.) Having dealt with all of the costs, the partner then gets to keep 100 percent of all receipts.

The extreme version of the system does have strengths. As every partner has total responsibility for his or her income and clients, partners know exactly what they must do to achieve the income levels they desire. The system provides incentives at various levels. First, the partners will want to bring in business for others because they get a percentage of the billing when they sell the file to another partner or when they get a junior to manage the file. There is also an incentive for hiring and retaining only profitable, hardworking juniors so that they can maximize their own incomes. There strong motivation for partners to collect their receivables because it is their own money. Lastly, the firm will maintain tight controls on spending because partners will not tolerate too large an overhead allocation. There is no pie splitting animosity because there is no pie splitting. Everything is dealt with at an individual level.

FORMULA SYSTEMS

Under a "pure" formula system an allocation methodology is set up which typically is designed to reward 'Finders', 'Minders' and 'Grinders'. Whilst firms might weight each

of these three areas, many will simply weight each with 33.3%. This then becomes easy to measure – you simply calculate the volume of work introduced, the volume for which the partner is responsible in terms of being a team manager and the volume which the partner actually generates from his own efforts. The formula then applies to work out each partner's compensation. There are many problems with such systems. First, we have encountered many formula systems which do not recognise or reward all the criteria necessary for a firm's success. A formula has to operate against numbers and some factors are intangible. Second, formula systems have been proved to be easy to manipulate. Third, formula systems are highly inflexible.

AGREEING ON A FORMULA FOR CREDITS ("ORIGINATIONS")

All surveys in the legal and accountancy sectors confirm the continuing importance of tracking originations. It seems that about 70% of firms who track originations continue to do so indefinitely with about 10% preferring to end originations after a number of years. For origination credits to work fairly, there must be agreement on the rules for the identification of the originator, for shared credits, for changing allocations and for ending (or not ending) the duration of the credit. The basis for the originations formula goes back to the 1940s, when the Boston law firm Hale and Dorr created what is regarded as the first incentive-based compensation system. Under a modified version of this, 10% of profits would go to the finders, 20% to the minders, 60% to the grinders and 10% to a discretionary pool for allocation on a subjective basis. One firm that still uses originations extensively is US law firm Flaster Greenberg. In that firm thirty percent (30%) of the total amount available for distribution is allocated proportionately to the shareholders based on origination, nineteen percent (19%) is allocated proportionately to the shareholders based on minding and fifty-one percent (51%) is allocated to the shareholders proportionately based on production. Shareholders receive the same production credit regardless of whether they work on a client file they originated or another attorney's file.

The firm argues "The financial credit for origination is divided into two categories – origination and minding, which allows attorneys to share credit for client acquisition and management. Accordingly, attorneys are rewarded for each step in a client relationship – bringing in clients, managing the file and performing the work. This means that minding attorneys are rewarded for servicing and growing the client.

The delicate balance between rewarding originators and rewarding the working attorneys is maintained as evidenced by the fact that both the firm's high originators and high billers have remained at the firms.

PITFALLS IN FORMULA SYSTEMS

In most major firms, the trend is away from compensation which is highly driven by partners individual client-related efforts. The biggest drawback is that such systems are anti-institutional. As such, they can be a good vehicle for smaller firms but are not really suitable for firms as they grow larger. Because no one gets recognition for non-client time, there is often a void when it comes to firm management, training of juniors, firm marketing or human resources. There is certainly no room for those with a global mindset. Additionally, such systems create no need for collegiality other than as a method to market other partners for work for their clients. Often partners don't even talk to their colleagues unless they have a financial or personal reason to do so. That, in turn, spreads throughout the firm, creating a very difficult environment for most staff, juniors and even some partners to work in.

One further huge drawback with performance based compensation systems is that they can become expensive nightmares to administer, if the metrics are not carefully selected. On the one hand, people do not as they are told but as they are rewarded, so the system needs to reward exactly the kind of behaviour that the firm desires. If practice leaders are measured on their individual contributions to billing, then they will not delegate, manage, coach or do anything else that fails to drive their individual billing. If securing new work is rewarded, existing clients will tend to be neglected. If originations are rewarded, then people will tend to pay attention to business development. [3]

SYSTEM THREE: AD HOC SYSTEMS

Although we have no explicit survey evidence to prove it, there are a great many professional service firms throughout the world who have historically allocated their profits and partner compensation on a fairly informal basis and continue to do so. We have however noticed that this exercise becomes more difficult and contentious once the firm grows to about fifteen or so equity partners, members or shareholders. Above twenty or so partners, formal systems and structures generally become necessary.

Many firms employing ad hoc compensation systems started as family or sole proprietor firms where the founder partner or partners set all the rules and provided all of the leadership and partnership control. As partners came in, they were allocated profit-sharing and compensation packages by the controlling partner or coalition of partners, and their shares tended only to increase over time if the firm leaders so decided or where the firm is faced with defections. Firms with strong and controlling leadership, whether or not from a founding partner, have much to commend them. The famous 'herding of cats' problems do not apply to firms where partners have to do what they are told. Such firms, however, usually find that both a spirit of entrepreneurship and continuing profitable growth of the firm will eventually become stifled unless heavy central control and dictatorship develops into a more sustainable institutional model. This generally leads to the formalisation of the rules for equity membership, progression and compensation.

Other firms have continued to adopt an annual negotiation where compensation allocations are discussed or fought over by the entire partnership. In some firms, each partner fills out a slip of paper with his or her compensation proposals and these are then aggregated. In some firms, this system is done anonymously; partners will see what other partners have proposed but they do not know who made which recommendation. A variation of this is the open method where partners know who recommended what. This can certainly lead to robust debate! Occasionally, a remuneration or compensation committee is appointed to apply rough justice without any detailed rules of engagement or criteria being agreed.

Ad hoc systems therefore can range from a heavily autocratic extreme to a predominantly democratic model where every partner is allowed an equal say in compensation setting discussions. They can work well or badly depending on the level of trust and the culture of collegiality within the firm. Partners generally need to have the comfort of knowing that their overall contribution to the firm is both known and being fairly taken into account. Systems which are perceived to favour the popular partners and those who are best at selling themselves and their accomplishments within the partnership often act to disconcert those who prefer to keep themselves to themselves, or work in more humdrum areas of practice.

SYSTEM FOUR: FOUNDER PATRONAGE SYSTEMS

As a variation of ad hoc systems, I have noticed some firms where the influence of the founder partner or group of partners continues to influence the profit-sharing and

compensation allocations. Founders often maintain an iron grip on their firms generally and a rigid control on the equity of the firm in particular. The introduction of new equity partners in the typical founder firm often takes place when the need for succession planning is identified, when the firm starts to stagnate (and needs an infusion of new talent) or when the firm's growth starts to outstrip the ability of the founders to control the growth within a rigid employment hierarchy. When founders recognise the need to introduce new equity partners, their mindset often is that they are 'giving away' a share in the firm to their new partners, many of whom have been employed salaried partners for many years and were chosen originally for technical skill rather than leadership qualities. This patronage mindset can continue for a long time after the firm is opened up to new blood and is demonstrated by the founders deciding all compensation issues against inevitable complaints of favouritism and arbitrariness.

SYSTEM FIVE: LOCKSTEP AND ITS VARIANTS

Under a Lockstep or seniority based system, an individual Partner, upon admission to the Partnership, is exchanging his own individual earning power and his own intellectual capital, for participation in a 'mutual fund' of other Partners. Through this, he is able to share in the joint future incomes of his Partners, some of whom will be his contemporaries and some of whom will offer differing levels of expertise and experience gained through the years.

A lockstep system has a number of attributes:

- Each Partner's share of Profits depends entirely upon his seniority
- In any given year, the relationship between Partners at different levels is pre-determined
- The system recognises that Partners take time to find their feet following entry to Partnership
- The system emphasises the mutuality of Partnership, and the sense of sharing and support which should exist between Partners
- Lockstep is essentially a sharing model of Partnership, emphasising the gains and

benefits to be had from diversifying opportunities and spreading risk amongst a group of Partners, and away from an individual 'eat what you kill' mentality

- The system distinguishes between the personal attributes and earning power of each Partner (his 'individual human capital') and what the firm's institutional capital – that which cannot be easily removed from the Firm, or duplicated outside it and described above

- The system encourages a more collegial environment in which Partners are encouraged to pursue the firm's best interests, rather than their own

THE PERCEIVED BENEFITS OF A LOCKSTEP SYSTEM

For a firm with a large element of firm-specific intellectual capital, the sharing or lockstep system has some important potential advantages. The main benefit is to provide outstanding diversification and to reinforce a culture in which clients are viewed as firm clients and in which efficient teamwork is encouraged.

In the case of many lockstep firms the client is regarded as central to their whole ethos, and for such a firm a culture of firm before self' is entirely consistent with a sharing, lockstep model of profit sharing. What is also clear is that the presence and level of firm-specific capital is so marked in such firms that they are potentially much more profitable for individual partners than alternatives outside the Firm. This in turn reduces the risks of poaching by other Firms. This is borne out by the research of Messrs Gilson and Mnookin[4] nearly forty years ago who found that the concept of firm-specific intellectual capital explains why some sharing firms achieve substantial efficiencies, tend to be amongst the most profitable professional service firms, and avoid some of the risks of partners grabbing clients and leaving the firm.

THE DRAW-BACKS OF LOCKSTEP

Lockstep is seen as having the following disadvantages:

- It does not deal explicitly with the issue of underperformers or shirkers

- It does not deal with the issue of exceptional high flyers

- It does not reward, sufficiently quickly, superior young Partners
- It can reward moderate partners to a greater extent than they deserve
- Even if underperformance is not a problem, nevertheless, in the world of professional services there is a fine line between the good partner and the excellent one.
- It can prove difficult to find the right pace on the equity ladder for lateral hires

In the Lockstep firm, the problem of shirkers and underperformers is seen as more of a management and development problem than a problem of reward. Firms with a Lockstep or Sharing system of Profit Sharing tend to be less tolerant of poor or mediocre performance than firms which make extensive use of individual performance based rewards. The attitude can be very much one of 'shape up or ship out'. The problem is that not every issue of underperformance results from laziness or lack of intellect. The underlying causes for underperformance can include:

- Cultural problems, including complacency, coasting and a desire to remain in a comfort zone
- Partners who have reached the limits of their capabilities
- Partners with personal difficulties or under stress
- Failure to understand why it is necessary for new approaches to be adopted or new tasks to be done
- Mental blocks on how to raise the game
- Conditions in the Market Place

The experience of a number of Firms is that a reduction in profit Share to cope with underperformance brought about by some of the causes listed above, can tend to demotivate the Partner still further with the result that performance levels drop still further.

TRENDS FOR FIRMS RETAINING 'PURE' LOCKSTEP

We see many firms across the world that are wedded to the concepts and values of 'true partnership' and equal sharing which finds its expression in the lockstep principle. However, many such firms are tending to sand down the edges of pure lockstep in order to maintain flexibility and the ability to manage performance.

As a Partner moves up the lockstep and grows within the partnership, firms generally expect his/her contribution to increase. This does not relate to the overall hours spent on Firm business or the degree of collaboration, but to the value that the Partner brings to the Firm. Firms very often therefore provide benchmarks and criteria which they wish to see partners attain as they develop through the partnership. These benchmarks are supported by training and coaching and monitored via appraisal . At the same time, these benchmarks and criteria will often provide the minimum acceptable standards for partners of the firm, protracted or persistent under=shooting of which will result in the partner being asked to leave. The more caring firms will sweeten this frightening prospect by providing for a period of intensive care and coaching to allow the partner to address his or her perceived shortcomings.

VARIATIONS OF LOCKSTEP (HYBRID LOCKSTEP)

More radical solutions have also made their way into the structures of many firms. Some 60% of UK law firms now report, for instance, that they have introduced some form of modified lockstep. This is particularly the case where firms do not want to admit new partners if those partners are going to progress automatically to parity. Equally, many firms are reluctant to go the whole way into a pure performance related system but wish to retain the flexibility to even out elements of unfairness and to make some measure of alignment between individual contribution and individual rewards. Many of these 'hybrid' systems seek to give partners two things. First, it gives certainty in that partners will know in advance what their guaranteed minimum income will be assuming the firm meets its financial targets. Second, partners know that they will also be rewarded for performance in due course.

What is important to bear in mind is that the system must support the firm in its growth and in the attainment of its objectives. We have seen many such modifications but they tend to fall into one or more of the following eight types.

Lockstep Hybrid One: Managed Lockstep

A managed lockstep is one where the progression up the lockstep ladder is assumed but not presumed. The firm will preserve the right in exceptional circumstances to hold a Partner at his/her current position on the lockstep, or even to reduce points, if that Partner's performance does not warrant progression. In addition, there will often be a "gateway" at one or two places on the lockstep through which a Partner can and will pass only if the firm agrees that he/she should progress further. Some firms also retain the right to advance a partner through the lockstep faster than the standard progression and in some cases to reduce a partners share.

Lockstep Hybrid Two: Lockstep plus discretionary performance related element

Another variation provides for Lockstep to apply to the major part of the firm's profit pool, but the remaining part of a partners profit share is performance related. There are two main methodologies currently in play. The first methodology divides the profit pool into two parts, with one part allocated to the lockstep and the other part reserved for performance related allocations. We have seen some firms allocate as much as 40% of the firm's profit for distribution on a performance related basis, but commonly the percentage is between 15% and 30%. The advantage of this methodology is that partners can often be persuaded to feel that, unless they are perceived to be underperforming, all partners will receive something from this part of the profit pool.

The second methodology provides for 10, 20 or 30 additional merit points to reward retroactively for superior or exceptional performance, but with a re-base to 100 points each year. Some such systems seek to restrict the effect of such a provision by providing that points for superior or exceptional performance are unlikely to be awarded to more than a fairly small percentage of partners.

Lockstep Hybrid Three: The Super Plateau

The super plateau system is a managed lockstep under which, having reached 100 points (which would be the points plateau for a firm operating with a lockstep to 100 points), an exceptional partner can then progress further to a super plateau which is reserved for a very few star partners. This super plateau generally operated prospectively in that partners are moved on to the super plateau on the assumption that future performance will match or exceed past performance.

Lockstep Hybrid Four: Lockstep plus formula bonus

A further variation gives a partner a formula bonus in addition to his points based profit share. This bonus generally operates as a first slice of profits and is based on a percentage of the partner's realised billings. This is not a popular system as it can reinforce tendencies to hog work and to be anti-collaborative.

Lockstep Hybrid Five: Exceptional bonuses for extreme high flyers

Some firms also provide for the ability to award an individual payment in order to reward a "one-off instance" of exceptional performance.

Lockstep Hybrid Six: A two tier system with a lockstep 'salary' element plus discretionary performance related element

Under this system, a partner will receive a 'salary' which will usually have some relation (at least at entry level) to a market salary for a professional of similar seniority and market worth. These 'salaries' are banded and partners will move up the bands in a similar way to lockstep progression. The aggregate of the 'salaries' payable to partners operates a first tranche of distributable profit, and the residual profit is then allocated on a performance related basis.

Lockstep Hybrid Seven: A three tier system – salary, ownership shares and performance related element

A further variation is designed to align partners' profit shares more closely to remuneration methodologies in the corporate world. Like senior employees of a corporation, a partner will receive a 'salary' plus a 'dividend' plus a performance related bonus. The 'salary' is either reviewed regularly on a market basis or simply banded with partners moving up and down salary bands in a similar way to lockstep progression. Again this salary operates as a first tranche of a firm's profit. The 'dividend' is received by means of the allocation to each partner of owners' points (sometimes known as Proprietorship Points) on lockstep principles. The residual profit (after deduction of the aggregate 'salaries', is then split between the amounts allocated for owners' points on the one hand and a performance element on the other.

Lockstep Hybrid Eight: Fixed Value Points systems

Firms operating internationally or with major profit differences between offices or regions whilst operating on a common profit pool usually build in some variation in the value of points. The invidious alternative is to vary the actual number of points allocated with the effect that eminent or senior lawyers in different markets will be on different profit shares, which can cause difficulties. In general, the points allocation to

each individual should be based on their peer group position on the lockstep, or their performance level relative to others, or a combination of both. However, it is then necessary to recognise and reflect differences in profitability between offices, or purchasing power differences, or both, by adjusting the value of points between the various markets. There is an important psychological issue in this approach in that it has all peer group partners on the same level of points so it is according to them an equal level of seniority or performance or both. This can be quite important in status terms and in motivation. People can feel undervalued if their level of points varies from their peer group: this is much less where the value of a point varies because of external factors.

SYSTEM SIX: COMBINATION SYSTEMS

It is very difficult for any firm entirely and radically to change compensation systems to an entirely new model. The vast majority have preferred an incremental approach to change. Hence, modifying a mainly formulaic or algebraic system to a combination system reflects the desire to maintain at least some of the attributes of a system to which partners have become used and in which they have some levels of confidence. The aim of a combination system would be to retain some elements of formula whilst assessing partners for overall contributions. The eventual objective might be to end up with three elements (like ibanks) of salary (to reflect effort and production), dividend (to reflect ownership state) and bonus (to reflect good contribution). The approach of firms has been multifold but some examples are

1. Formula plus Subjective Assessment. A combination of an algebraic formula based on performance with a subjective element based on a balanced scorecard. One accountancy firm mentioned in Aquila and Rice's book [5] for instance used a 75% formula approach and 25% for subjectively assessed performance

2. Base salary plus formula. All partners receive a base compensation (Salary) fixed at market rate or as a proportion (say 60%) of their average compensation over the past three years and the balance of the firm's distributable profit (after deduction of the aggregate salaries) based on formula. The latest Rosenberg survey found that 86% of CPA firms have a base salary tier. The base salary, usually 65-75% of total compensation, is both the historical and street value of a partner and gives both established and incoming partners confidence that their basic financial needs will be met

3. Formula Salary with the balance assessed on a subjective basis that takes into account overall contribution

4. Salary with a proportion of the residual profit being subjectively assessed and a further proportion being carved out into a bonus pool for allocation after year end for exceptional performance in that year

5. An alternative approach is for all senior professionals to receive a base salary which reflects their efforts and status as working professionals with the remainder of the distributable profit being allocated through a combination of the existing formula and an adjustment to reflect non-financial contributions.

MAKING SENSE OF IT ALL: SEVEN STEPS TO SUCCESS

In our fast-changing world, with a bewildering choice of different compensation systems, it is vital to work through seven critical steps.

STEP ONE: SUPPORTING THE FIRM'S STRATEGY

By far the most important aspect of a firm's compensation system and underlying policies is that it must support the firm in achieving its strategic and economic objectives. The system needs to help to underpin a unified understanding of where the firm wants to go, where it is likely to prove to be successful and what trade-offs are likely to take place along the way. Sadly, many compensation systems reward the past, and perhaps the immediate and short-term future; those who are working prospectively towards longer term goals can lose out in the pie sharing contest.

STEP TWO: ALIGNMENT WITH THE FIRM'S BUSINESS MODEL AND STRUCTURE

The firm's business model is the framework by which the firm competes, generates revenue and delivers profit. For many firms there is an uneasy balance between high volume, low margin work at one extreme and lower volumes of 'bespoke' one carried out at high partner rates at the other extreme, and these difference need to be taken into account in assessing the value of partners' contributions. The firm's structure – partnership, limited liability partnership, LLC or corporation – is also a vital determinant of compensation alignment.

STEP THREE: ENCOURAGING THE RIGHT BEHAVIOURS

Third, the system must encourage the behaviours, performances and contributions which will assist the firm in meeting its goals. Whilst this may seem obvious, there is a worrying trend towards encouraging and rewarding short term behaviour at the expense of longer-term investment. This means making sure that the firm clearly defines what it needs from its partners and – if possible – ensuring every partner has a written business plan and specific goals.

STEP FOUR: FOCUS ON COLLABORATIVE EFFORT

Fourth, it must assist towards the development of a cohesive organisation by focussing on collaborative effort. This makes for a difficult balancing act between the encouragement of individual performance and the drive for better teamwork. The hogging of work to boost personal performance is still an issue in most firms.

STEP FIVE: IMPROVEMENT OF LONG-TERM COMMITMENT

Fifth, the system must improve commitment, engagement and enthusiasm to aim for further and better business success. As I have suggested elsewhere[6], we all spend large proportions of our lives at work and we owe it to ourselves and our firm that our career and the environment in which we work should be stimulating, satisfying and even fun. I would go further and suggest that the pursuit of happiness in our firms is more important than the pursuit of profit.

STEP SIX: DEVELOPING THE FIRM AS AN INSTITUTION

Sixth, it must assist the firm in developing as (or into) an enduring institution by concentrating on the development of its intangible assets – those features that make the firm unique and competitive, such as specialist niches, systems, processes and know-how. Included as important aspects of any firm's institutional capital are its ethos, internal ecology, expected sets of behaviours and ways of doing things – in other words, its unique organisational culture. The compensation system should acknowledge and support the assets and value of the firm as an ongoing institution, taking into account, in particular, the value of the predictable flow of work from an established client base, the ability for partners to work from established premises and with the firm's systems, equipment and staff, the reputation and name of the firm and the consequent value of the firm as a means of quality assurance to existing and potential clients. Other factors in the firms institutional capital include the efficiencies and economies of scale associated with the firm, its collected know-how and applied knowledge and the synergies obtained from the development of expert teams across a broad range of professional disciplines.

STEP SEVEN: COMFORT AND CERTAINTY TO PARTNERS AND MEMBERS

Finally, over many years of experience we have consistently found that partners and owners of professional firms need the following for their systems of compensation:-

- Transparency, certainty and predictability – the system needs to be easy to understand, the processes easy to follow and any judgements or assessments seen to have been made with scrupulous sincerity
- Security – they need to know they can fulfil at least their basic monthly financial needs
- Good accounting practice – any (such as accountants) with a financial background need to know that the system is credible, logical and not overly complex
- The absence of major change – we have found time and time again that it is difficult to get partners/owners to agree a whole-scale transformation of the compensation system; incremental change is preferred
- Fairness – in particular, partners/owners are reluctant to feel they are likely to be subsidising colleagues who they perceive to be slacking or under-performing
- Overall contribution is valuable – most (but not all) want to feel that their overall contribution is taken into account and not just their financial performance.

CONCLUSION

The ultimate choice of profit sharing system depends very much on the specific firm's history, culture, jurisdiction, size and maturity. Our own preference is for a system with a meaningful performance related element of compensation or reward which is based on a qualitative assessment of every partner's total contribution to the firm across a number of critical areas of performance. However, such a system will not suit every firm. We are seeing many firms still seeking to stick as closely as possible to what they see as the true partnership ethic which equal sharing and lockstep represents. This is particularly true of those firms with large elements of firm-specific intellectual capital, such as the London magic circle firms and leading New York firms. It is also clear that some firms in start-up mode or in a period of entrepreneurially driven growth will continue to be attracted to the

relative simplicity of an Eat-What-What-You-Kill system. There will also continue to be a body of firms which are either heterogeneous motels for professionals or where both the business model and the emphasis are on individualistic business builders and fee barons. For such firms the more formulaic models of compensation will continue to have their place.

What is clear is that every system requires active and robust management to ensure that partners do not creep their way up to progression beyond their competence and contribution.

[1] The Edge International Global Compensation Survey

[2] The Rosenberg Survey 2019

[3] See the Ten Terrible Truths about Law Firm Partner Contribution by Ed Wesemann (August 2006) available from www.edge.ai

[4] Gilson & Mnookin – Sharing among the Human Capitalists: an Economic Inquiry into the Corporate Law Firm and how Partners split Profits (Stanford Law Review January 1985)

[5] Aquila AJ and Rice CL (2007) Compensation as a Strategic Asset

[6] https://jarrett-kerr.com/ten-steps-towards-a-happier-firm/