ABOUT THIS WHITE PAPER

In early 2015, Aderant embarked on a research study about partner compensation. This six month research project involved a review of industry studies, interviews with industry experts and five Aderant Leaders in Law events held around the U.S. These discussion sessions were attended by managing partners and senior leaders from more than 50 top U.S. law firms.

For the research project, Aderant focused on the following key questions:

- How are law firms currently structuring their partner compensation systems?
- Which models are the most widely used, and why?
- What are some of the primary challenges firms face in determining partner compensation?
- Which measurements are firms using to determine remuneration?

This report summarizes Aderant’s research, including feedback from industry leaders along with prior published industry research.
YOUR PARTNER COMPENSATION SYSTEM CAN BE BETTER: HERE’S HOW

If you’re an equity partner in a law firm, you have likely experienced firsthand the advantages and drawbacks of your firm’s partner compensation system. Undoubtedly, many equity partners are satisfied with their current compensation and their firm’s process that determines it. According to recent surveys, however, a growing number of equity partners are not satisfied with their firm’s compensation system and would like to see changes made. Interestingly, this partner dissatisfaction seems to be true even if the types of partner compensation systems in question are vastly different.

While partner compensation systems worldwide span the full spectrum from purely subjective to purely “lockstep,” many lawyers report that their firm struggles with the process. That’s not surprising, considering that issues of fairness, how to properly measure a partner’s contributions and determinations of who gets what can challenge even the most stable firms—and the ramifications of such decisions can often linger for years.

When asked about possible changes to their partner compensation system, however, partners say that there’s no one-size-fits-all solution. Each firm has its own separate revenue issues, personalities and enduring culture. A common firm dynamic, for example, may require rewarding many different partner behaviors, or even over-compensating senior partners whose client value has declined.

As compensation committees wade through this remuneration minefield each year, they may want to consider whether better information—better metrics—could improve both the transparency and fairness of the process. Regardless of the compensation model a firm has in place, technology now offers firms an opportunity to examine performance and profitability metrics at the individual partner level. When the difficult, even controversial compensation decisions are supported by data analytics, some of the more personal and emotional aspects of the process can be reduced.
COMPENSATION SYSTEMS VARY BY REGION, BUT MAINLY TWO

Back in 2001, the Managing Partner Forum described compensation models as falling into the following seven 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

More recently, however, partner compensation has coalesced into two basic approaches: subjective systems and so-called lockstep systems. In each case, the exact form that a subjective or lockstep system takes will depend on the particular firm, with literally dozens of variations on each model. In addition, an interesting divergence has occurred between North American firms and the rest of the world in the preferred type of compensation system.
In their 2015 Global Partner Compensation System Survey, Edge International found that “As the practice of law becomes an increasingly global enterprise, the cultures of the law firms involved in international practice are becoming more homogeneous. Nowhere is that more apparent than in the processes that law firm partnerships use to determine partner compensation.” According to the Edge survey, the current state of partner compensation systems worldwide can be summarized as follows:

- U.S. and Canadian law firms lean much more toward subjective compensation systems than firms in other countries.

- Lockstep as a base method of compensation is the preferred system among law firms around the world with the unique exception of North America.

More specifically, the Edge survey reported seven basic variations of the two dominant compensation systems, consisting of:

1. **Lockstep**, which sets fixed levels of percentage participation in a firm’s profits according to a predetermined set of progressively increasing steps, usually based on seniority.

2. **Equal Distribution**, which is a form of lockstep in which all partners are paid equally.

3. **Modified Lockstep**, involves a lockstep schedule for part or all of a partner’s compensation; this can be accelerated, decelerated or managed based upon individual performance.
4. **Formula**, where compensation is determined by a quantitative formula based on each individual partner’s statistical performance.

5. **Combination**, where compensation is based on statistical performance but the application of the statistics may be subjectively modified.

6. **Subjective**, a system where compensation is determined based on the subjective decisions made by a person or committee, although inputs to the decision may include statistical information.

7. **Corporate**, which is a normal business model where partners receive a salary and bonus based on performance and then are paid dividends based on the profitability of the firm.

Since each method has the same stated goal—fairly compensating each partner for their contributions—the importance of form can be overstated. At a recent Aderant Leaders in Law series event on partner compensation, for instance, Attorney Michael Short of the LawVision Group noted that “there is a perception that [lockstep] systems just run automatically and don’t include any management or difficult discussions (such as those needed for a successful subjective comp system). However, quality of people and consistency of service are important characteristics of a successful lockstep system and the partners have candid discussions with each other in this system too. In the end, all systems are far more similar than they are different.”

**“OPEN” SYSTEMS DOMINATE, EVEN IF PARTIALLY CLOSED**

In most firms, the partner compensation is said to be “open” in that, in theory, any partner in the firm can learn what each partner is earning. The Edge Survey found that open systems are becoming more popular, and in the U.S. 92% of firms reported operating under open systems. As Edge noted, however, there are “a wide-variety of restrictions on what constitutes ‘open’ including some ‘need to know’ provisions, i.e., practice group leaders and partners involved in assembling client service teams, and ‘availability upon request’. A common restriction is that partners may view the information in the managing partner’s office but may not copy or remove it from the office.”

Alternatively, in order for a closed compensation system to work, partners have to trust the compensation committee. In turn, the compensation committee must then trust the audit system they put in place to ensure committee members themselves are compensated fairly.
MOST U.S. PARTNERS WANT TO CHANGE COMPENSATION METHODS

The 2014 Partner Compensation Survey from Major, Lindsey & Africa (MLA), based on 2,083 respondents, found that firm partners in the U.S. are faring well in a recovering economy. The survey found that average partner compensation was up 5% from 2012, to $716,000. What’s more, the gap between equity and non-equity partner compensation had grown wider. Equity partner compensation averaged $971,000, compared to the non-equity average of $338,000.

Absent any other context, those numbers suggest that equity partners should be happier than ever with their compensation system, since it’s producing growth in a challenging legal market. One factor seemed to be weighing on partner satisfaction in the survey, however: the growing importance of originations in compensation decisions. The MLA report highlighted that “Now more than ever, compensation is driven by a partner’s ability to bring in revenue. 74% of our survey respondents consider originations to be Very Important when determining compensation and 66% cite originations as the most important factor. 55% of all respondents consider originations as becoming a more important factor than in the past.”

Perceived Importance of Factors Determining Compensation (2014)

In a key finding, the survey found that 65% of the respondents would like to see a change in their compensation methods. And the suggested changes included:

- Increased transparency
- More recognition for good citizenship and team work
- More appreciation for cross-selling
- Less emphasis on originations
- Less emphasis on billable hours/working attorney receipts
- Less value placed on firm management
- Greater value given to specialized practices
- More consideration for non-billable hours
- Reducing compensation of non-performing lawyers faster
- Less cronyism

This feeling of dissatisfaction was also expressed during the Aderant Leaders in Law events. Even though partners willingly acknowledged their very high compensation rates, their dissatisfaction usually stemmed from subjective methods, which they believed overpaid some and underpaid others.

In a related finding, only 45% of partners felt that their compensation was “about right”, leaving 55% unsatisfied.

![Satisfaction with Compensation Level](image)

*Source: “2014 Partner Compensation Survey.” Major, Lindsey & Africa 2014*
PROBLEM WITH CURRENT “SELF-LIQUIDATING” COMPENSATION SYSTEMS

In early 2015, the ABA Journal ran a piece by business lawyer Edwin Reeser titled 9 Ways To Change The Carnivorous Partnership Model And Save Biglaw Firms, which detailed the challenges of current partnership structures. Mr. Reese argued that:

Few partners are made relative to the numbers hired from law school, and fewer still are homegrown. In many firms the number of lateral partners admitted over the past 10 years significantly exceeds the home grown partners. Furthermore, those who make partner still tend to be net givers to the profit pool for many years after they make partner. (A net giver is a person who contributes more in personal service and client book dollars to the firm than they are paid, after costs.) In most law firms, that is a significant majority of the equity partners, all of the income partners and of counsel, and most of the associates that actually do generate a profit.

That being the case, he further suggested that firms need to create incentives for partners to “work towards a model that is self-sustaining into the future, not self-liquidating in the present. That compensation model should focus on the long-term strengthening of the institution of the firm over the short term remuneration to the partners.” One of his key recommendations was that partner compensation should be based on the profitability, rather than gross revenue, of their practice originations.

The idea of profitability as a compensation metric was a hot topic discussed at Aderant’s Leaders in Law discussions. While many firms are already measuring profitability, however, very few use the metric in compensation decisions. Some voiced concerns that too much emphasis on the metric may motivate partners to reduce resources in order to boost profit, at the risk of quality. Others feared their firms simply don’t possess solid, reliable profitability data on which to base partner compensation decisions.

On the Law21 blog last year, Jordan Furlong asked firms to 1) stop over-valuing sales, and 2) start properly valuing everything else. He proposes the idea of a firm where partners spend much of their time on firm-level activities, rather than cranking out billable hours and pursuing new originations. Finally, Mr. Furlong proposes that lawyers:

Imagine a firm where partners received no compensation credit for billed hours. Think for a moment about the change that adjustment would induce in how partners keep themselves occupied. What would they do all day? How would they apply themselves to the development of their expertise, the increased productivity and profitability of their practice and the firm, and the firm’s future development and prosperity? And if it turned out that a given partner had no interest in doing any of these things, then why is that person an equity holder in the first place?

In most law firms, the compensation system is the only really effective instrument for influencing behavior. But there’s no rule that says it has to be a blunt instrument.”
The consideration of profitability in partner compensation systems is not new, but until now it has not been widely discussed. That seems to be changing. While it’s still true that most firms don’t make proper distinctions between profitable and non-profitable client books of equal revenue value, for example, some firms are starting to use profitability as a metric in their compensation systems.

The challenge for firms wanting to measure profitability seems to be a lack of understanding of how to measure it, and then include it in a compensation determination. In addition, some partners are opposed to focusing on profitability on more traditional grounds, since a high-revenue rainmaker could stand to lose a lot if their matters were judged to be less profitable than others.

In a 2014 book titled Client Value and Law Firm Profitability, legal consultant Jim Hassett, Ph.D. confidentially interviewed 50 leaders of large firms. In an excerpt published by Altman Weil, Dr. Hassett wrote that firms are indeed paying more attention to profitability and to its role in compensation. He anonymously quoted the following “senior executives” of firms arguing that the trend arrow is strongly pointing towards a focus on profitability:

“When things were going well, it was easier to take care of the worker bee partners, who are great lawyers. It’s going to be tougher now, because everybody’s strategy is through lateral hiring, and you don’t want the great brief writer. What you want is the person who has five to eight million dollars following him or her, or the group that’s going to bring 20 to 30 million dollars.” – Senior Executive

As the pressure goes up, the emphasis on total revenue is being replaced by an emphasis on profitable revenue:

“Historically, virtually all law firms over-weighted revenue. Often two partners who produce five million dollars each are treated equally for compensation, even if one of those partners used six and a half million dollars of resources to produce that revenue, and the other used three and a half million.” – Senior Executive

“We merged a few years ago with a firm that principally focused on total dollars in the door and allowed billing attorneys to set their own rate exceptions without much oversight. We focused on those decision points that reduced realization, and the lack of profitability in a million dollars received that takes two million dollars of effort to generate. Consistently reinforcing these basic concepts through our BI tools and in the compensation system has resulted in significant margin improvement.” – Senior Executive
In fact, overall industry profitability is on the rise thanks to a shift in perspective in many firms. The 2015 Client Advisory from Citi Hildebrandt found that the legal industry’s profit margins and profit growth for 2014 surpassed the prior year. The essential factor driving this rise is an increased focus by firms on margin growth, rather than just revenue growth.

The report found that “Beyond looking at margins at the firm level, firms are looking at profitability by client, matter, practice area and office. In the 2014 Law Firm Leaders Survey, 92% of large law firm participants are measuring profitability by client, and a high proportion measure profitability by matter, practice area and office.” In particular, “Law firm leaders are facing the challenge of shifting the mindset of their partners to view their most important clients not so much as being their top revenue generators, but as the ones who are the most profitable.”

### Profitability Analysis

Do you measure profitability by:

- **Client**: 92%
- **Practice area**: 89%
- **Matter**: 84%
- **Office**: 80%
- **Partner**: 78%
- **Fee earner**: 48%

% of Responsibilities

Source: “2015 Client Advisory.” Citi Private Bank and Hildebrandt Consulting

December, 2014
By tweaking the formula, leaders can better recognize and reward lawyers who contribute at different points in the process.

**CAN A PROFITABILITY METRIC WORK IN A COMPENSATION SYSTEM?**

In a recent post on [Matter Profitability](#), ABA Law Practice Today noted that introducing a new metric into the partner compensation system can prove tricky. The status quo, regardless of its faults, will always carry tremendous weight in a successfully functioning firm. On the other hand, firms that already include some objective measures in their compensation model probably won’t have difficulty adding a new profitability metric.

But firms using fairly straightforward measures, such as realization and billable hours, will likely resist any metric that they can’t control. Law Practice Today advises such firms not to give up on profitability, however, since “the partners in that firm are already gaming the system. Assuming the firm cannot change to the individualized partner compensation system... it may be better off realigning its metrics to incentivize profit-producing behavior, despite the effort that will require.” They even recommend gaining partner “buy-in” by introducing the profitability metric to the firm long before using it in compensation decisions.

Legal Consultant [Timothy Corcoran](#) wrote about partner compensation being the “third rail” of law firm management. Partners won’t change the status quo unless they are compensated for it, and the arguments must be convincing. Mr. Corcoran argued that the profits versus revenues compensation conundrum is dealt with successfully every day in the business world. He poses the following questions to emphasize how firms could begin to think differently about profits:

> Do we reward the high-volume hunter salespeople who bring in the most new clients but also the most unhappy clients (because of a poor fit) and who require the highest commissions? Or do we reward the farmers who nurture key clients over time but generate less incremental revenue? Do we compensate more for selling high-margin products, often because there is little competition, or do we compensate more for selling low-margin high-potential products, because gaining market share is more critical? Do we compensate for profits, even though salespeople have little influence on the cost of goods sold? It may seem complex but relatively simple calculations can help us identify the optimal approach.”

According to Mr. Corcoran, originated hours are the primary focus of most firms at present, but “By tweaking the formula, leaders can better recognize and reward lawyers who contribute at different points in the process.”
Assuming that partners are willing to consider a profitability metric as part of their existing compensation system, do the proper tools exist to make this possible? Since by their nature compensation decisions are fraught with emotion and may be challenged, all data metrics would need to be clear, accurate and easily explained.

Fortunately, the technology now exists to make this possible. Various business intelligence tools offer firms the ability to take raw data and convert it into actionable metrics. For example, firms can now benchmark partners on targets, budgets or previous performance, and can easily track pre-defined performance and management metrics. Newer software applications even make suggestions when specific performance areas appear to be lacking. In other words, firms can easily now drill down into their data to produce reliable, actionable information for strategic decision, such as partner compensation.

In Dr. Hassett’s book on *Client Value and Law Firm Profitability*, a senior executive at a firm that bases compensation partly “on accrual-based profitability” exemplified this process:

> We use dashboard tools... to track key metrics and responsibilities for each attorney as a working, billing, and originating attorney. This information is directly used in each person’s annual review and compensation setting, along with qualitative and subjective elements. They have visibility to this key information every day, and it begets a whole different sense of responsibility and accountability.”

It’s also important to remember that every firm is different, and profitability metrics need to be customized for each individual situation. No two firms will view profitability exactly the same—or even carry the same profitability reporting methodology—and partners will likely argue over which metrics make the most sense. Technology companies have adapted to this fact, however, and now tailor their business intelligence products to meet the particular needs of their client firms.
EMBRACE DATA TOOLS TO IMPROVE YOUR COMPENSATION SYSTEM

According to the recent statistics on partner compensation, more than half of your partners are likely dissatisfied with both your firm’s compensation system and their individual compensation. While a certain amount of displeasure will always be present in matters determining what a partner is worth, this number is too high to be a net positive for firms. Dissatisfied partners will likely start evaluating their options, and may end up joining the growing wave of lateral defections.

In firms where the partner compensation process is particularly fraught, it probably stems from an overall sense that the decisions are arbitrary, unfair or lack transparency. By adopting the available data tools that now allow firms to evaluate performance using clear metrics, partners could avoid much of the lingering suspicion of the compensation process. Not to mention the need to deemphasize the current laser-focus on originations as the primary component of compensation decisions. No system is perfect, but business intelligence offers a much stronger basis for a robust compensation system that rewards profitability.

Law firms are not unlike any business that consistently faces employee turnover due to compensation issues, but with one major difference—law firms can largely address this dissatisfaction without simply distributing more cash, but by using more objective than subjective methods when making compensation decisions.
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