Fixing Firm Compensation Models
To Fuel Value Focused Legal Delivery Systems

A four part series co-authored by a Fortune 500 GC, a Managing Partner, a leading practitioner in alternative fee arrangements, and a management consultant.

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As Published in The Los Angeles Daily Journal
During November 2009

INTRODUCTION

In this second series of articles on Alternative Fee Arrangements, the four of us have attempted to explore how a progressive firm might deal with one of the great impediments to adopting any new change – your firm's compensation system. And while there is no one standard framework or precedent to follow, each of these articles is attempting to provoke you to look at this challenge through a slightly different lens.

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If You Pay For Hours, You Get Hours

We've defined in earlier essays a value focused legal delivery system as one that is based on the true meaning of partnership between law firm and client through sharing of risks and rewards. There are many variants, but the critical element for all of them is there needs to be some portion – if not all – of the fees at risk coupled with a "true up" based on effectiveness, efficiency and customer satisfaction – in other words, value. It is a fundamental precept that you get that for which you pay. Firms built on originating credit, realization rates, and the leverage of associate hours all focus on top line revenue growth as opposed to profitability to the law firm arising from reducing costs and providing effective services efficiently cannot expect to see material changes in behavior. The existing compensation structure fosters inefficiency at the client's expense and creates free-agent lawyers with books of business to change firms whenever the compensation looks better elsewhere. Existing compensation systems do little to assist the firm in retaining its best and most valuable people. Thus, in this world, it is the individual lawyer, not the firm, whose interests come first. This is a zero sum game where the firm, one's other partners, and the customer suffer as the size of the slice of the pie is fought over. These "free-agent-what's-in-it-for-me" compensation systems stand in the way of meaningful progress.

One might look to the corporate compensation models in any public company proxy for inspiration to address this dysfunctionality. Here's a rather conventional structure to address each of these problems:

1. ***All firm employees are precisely that – employees.***

Each person has a pay grade that is based on their role, their education and their responsibility. This might mean all incoming lawyers start at one salary level – but they would not move in lock step based solely upon their law school vintage. Obviously, those at the top of the organization (by position, not vintage) would have a higher salary than those at the bottom. Those at the top are responsible for running the enterprise, planning for its long term sustainability and reinforcing firm culture from the top. These folks would constitute a C-Suite just as in a corporate environment. Practice group heads or regional office heads would be equivalent to division or general managers. There might be a linear, pyramidal structure or a matrix structure with compensation structures reflecting those models. All employees would have annual objectives, annual reviews and annual development plans. Each employee should be paid at a percentage of the midpoint of the pay grade based upon performance (e.g., those rated "needs improvement" at less than 95% of midpoint, "good" at 95-105%, "outstanding" at over 105%). There would be an annual salary pool for the enterprise that would be set each year as part of the budget process. Each manager would be responsible to divide their pool among their direct reports – some employees would get more, others less – all based upon performance and the manager would thereby be forced to stack rank their employees to stay within the budgetary constraints of the firm as a whole.

2. *Annual Incentive Compensation would reflect performance*

Each upper and mid level manager would have a "target" bonus defined as a percentage of base salary. The CEO might have a 100% target, other C-Suite members, 50-75%, GM's and Division Mangers, 40%, Managers 30%, other professionals 20%, and other staff 10%. This target would be the base for a bonus calculation reflecting overall enterprise performance as well as individual contribution. For example, in order to encourage overall business performance, 70% of the base or target bonus might be subject to a multiplier of 0-3, with a 1.0 reflecting budgeted performance. If the enterprise exceeded budgeted profitability, the multiplier would be higher, if it failed to meet budget, the multiplier would be lower - - or even 0. Individual performance and contribution would be rewarded in the same fashion with accomplishment of specific time based and measurable goals affecting the multiplier of the 30% of base or target bonus. A simpler structure reflecting only enterprise performance might be used for lower level professionals and the other staff. This structure encourages both a focus on overall enterprise profitability as well as individual contribution.

3. **Long Term Incentive Compensation would foster growth, ROI and retention**

The employees need to be stakeholders in the long term growth and prosperity of the enterprise. In public companies, this is accomplished relatively easily through the use of options, stock appreciation rights and restrictive stock – all of which vest in the future. Unless firms become publicly traded (e.g., as in Australia and New Zealand), parallels from the private company and private equity worlds need to be adapted to law firm structures. In either case, such equity type grants encourage growth and create "golden handcuffs" making departure expensive as the employee forfeits that component of future compensation. As such, this makes retention of key employees easier. For those really interested in long term prosperity, performance based grant multipliers could also be used.

Moving away from lockstep, eat what you kill, originating credit, leveraged pyramid, top line revenue focused compensation models, and towards these three elements, when combined with alternative fee structures based on effectiveness, efficiency and customer satisfaction, would further enable transformation of the legal service delivery model. The status quo will resist such change because it necessarily means dislocation, redistribution of income and acceptance of performance-based risk. If, however, you believe that such change is necessary or indeed even inevitable, those firms that move to a more corporate styled compensation structure will be better able to survive and prosper as enterprises.

Partner Compensation
And The New "Value" Reality

Imagine this: The Managing Partner of one of the largest law firms in the country is looking around the conference table at 20 of his partners. The 20 partners are the firm's highest compensated partners, collectively earning nearly $60 million in each of the last three years. Somberly, the Managing Partner informs the group that he has concluded that the firm's compensation system, which has been in place for the past two decades, must be scrapped. They wait for him to explain how the new system will favor them so the group can continue to receive generous compensation. "The days of paying people based on gross revenue generation are over. From now on, compensation will be based on net profitability of work."

The likely outcome of this meeting: It would only be a matter of days before the Managing Partner is replaced, or some of your fellow partners start exploring their options at other firms.

This story only sounds apocryphal. Instead, this scene will play out as law firms are forced by the "changing economic dynamics" to restructure their business models into something that eliminates the focus on top-line revenue growth and client-insured profit. Instead, the focus on profit margins, lower cost production and results instead of hours and body count will fundamentally alter the way law firms measure, and reward, the value their lawyers deliver.

The first challenge is to eliminate the concepts of "lone wolf," "rainmaker" and other solitary figures from the firm psyche. Rhetoric notwithstanding, many firms have rewarded revenue generators so lavishly in comparison to the lawyers who do much of the work for the rainmaker's clients that they have fostered a "what's in it for me?" mentality on virtually every issue. Instead of looking first to the interests of clients, many partners first consider whether a course of conduct will provide career security or additional income. The significance of the problem is magnified by two factors: first, the senior partners most likely to be in a position to ask this question are the people most likely to be able to add value or decline to do so. Second, the problem is so pervasive that many partners don't even bother to ask for input from another partner. Any senior partner who challenges the system is a threat to every other senior and powerful partner -- a no-win scenario.

The result of this behavior is that no matter how large a firm might be, it is comprised of individual silos. The partner builds his or her team, but there rarely are multiple "star" partners working on the same matter, no matter how complicated. Are we really to believe that one senior partner does not benefit from working closely with another senior partner on matters? If we do not believe this to be true, it seems inescapable that the state of affairs is influenced primarily, if not entirely, by compensation schemes.

Standard “eat what you kill” compensation schemes also are unhealthy. No amount is ever “enough.” Instead, “enough” is defined as “more than” somebody else or some other group. The amount of time spent tearing down “the other guy” or complaining about minor compensation differences is enormous and wasteful, and particularly offensive in light of the amounts partners, especially senior partners, are paid. Compensation systems should attempt to minimize or eliminate destructive behavior among partners. Firms where partners routinely collaborate invariably report that exceptional value is derived from these efforts.

The second challenge for law firms is to determine what kind of compensation system will encourage that collaboration.

In a smaller firm it always seems so much easier to imbue systems that encourage and reward collaboration. The best way to guarantee that the first question on everyone’s mind is how can we get better results for this client (and hence for the firm) would be to remove the ability of any partner to influence his or her compensation by a course of behavior different than the collaborative behavior the firm sought to maximize. You can accomplish that by deciding to pay partners the same amount. This was called the “rising tide raises all boats equally” compensation system.

The result of this system can be extraordinary. There is no destructive internal competition. Partners not only do those things in their comfort zone, but also are eager to help colleagues, because helping colleagues improves performance, which improves profitability. Partners are eager to accept assistance for precisely the same reason. This feature also has the collateral benefit that no time is spent at year end figuring out who gets what. There is no weighing of the relative value of one person’s contribution versus another’s. Such conflicts are inherently counterproductive.

As your firm grows and new partners are added those new partners need not be paid the same as others. It is enough that there is a fixed ratio between one level and the next. So, for example, newly admitted partners with lesser experience may earn at a rate of 80% of the original partners.

In a larger firm, there may be three or perhaps four compensation bands. The criteria for movement from one to the next, in either direction, would have to be articulated specifically and transparently for each individual firm to reflect the nature of its practice and culture. The goal would be to avoid the kinds of small scale distinctions among partners that foster the petty and destructive feelings of jealousy that so interfere with cooperation and collaboration.

While not the same as the “corporate model” addressed in the first article in this series, this “banding” approach serves many of the same purposes. First, and foremost, it ties everyone’s compensation to profitability of the enterprise. This result, move than any other single thing, puts people in the same boat. A fee system that rewards the firm’s performance further enhances this notion of common sacrifice and common benefit.

The compensation banding approach is not new or revolutionary to the practice of law, but their application has been corrupted to the point where there are almost as many bands in some firms as there are partners. Firms have, intentionally or not, created classes of lower tier partners working to deliver profits that are transferred to that upper tier of partners invited to the conference table. The amount of "rainmaking" gross revenue generated separates those in the upper tier, but without regard to profit created by that work.

The banding approach does not directly eliminate the "free-agent-pay-me-more-or-I'll-shop-my-book-of-business" extortion that some individual lawyers practice. It does, however, minimize the influence of those inclined to play that game. Because the alternative fee model eliminates the value of armies of faceless associates and de-valued "income partners" (highly capable and hard working lawyers who just don't happen to have the primary client relationship) working by the hour on a matter, the body count of the team assigned to a matter is eliminated. Instead, the value from a fee standpoint comes from obtaining a result, and a small team of experienced attorneys will fare better. This puts more people in contact with the client and enhances the value of the team, which reduces the prominence of the individual. Clients who are getting better results from a firm's team are less likely to want to move to another firm, especially if that other firm is not using the same dynamic fee system.

Clients benefit from this system because the collaborative efforts of the partners will produce better, more cost effective results than the silo system now prevailing. Clients also will be able to more easily see through the marketing rubric because the most profitable firms will achieve that status because they are the most successful in achieving their client objectives.

These changes will not come easily if at all at most firms. The vested interests and power of the entrenched beneficiaries of the status quo will stand firm to thwart the changes needed, since the old guard are the ones most likely to be relative losers under the new system. The thinking is that they paid their dues to a system where this was the way compensation worked, and now it fairly should be their turn at the trough. But the cheese has been moved for everyone. It is a fact in today's law firm world that you get what you pay for. Designing a system based on economic alignment, results instead of hours and cooperation and collaboration rather than competition among partners will make for better law firms and more satisfied clients.

Is Your Compensation System A Problem?

It might be very useful to have the lawyers in your firm engage in a thought experiment. What we need to do is imagine that our firm, suddenly, could no longer rely on billable hours to determine any partner's compensation. So here's the question for your next partner's meeting or retreat: "If we never billed another client by the hour, how would we compensate our fellow attorneys?"

Now to set the stage for your discussions, it might be valuable to just explore with the group, the many ways in which our traditional systems for compensating professionals have had some rather perverse side effects.

THE PERVERSITY OF BILLABLE-HOUR BASED COMPENSATION

For example, according to the reports of many spouses, they have had a noticeable effect on the self-worth of those lawyers who take immense pride in what they think they are worth (by what they can charge) on an hourly basis. Can't you just hear the typical conversation at home when some attorney says to their spouse; "What do you mean take out the garbage? Do you realize how much I charge clients for my time? I'll hire someone to do that job if you think it's so important."

Billable-hour based compensation has had an effect on what we perceive to be camaraderie, as colleagues take congratulatory pride in working to all hours of the early morning, night after night, week after week, and year after year (all to be billed to some client).This traditional emphasis for relying on the billable hour as our primary metric has also caused many firms to weigh different contributions in a rather pertinacious manner. There are countless examples of where we reward work done (grinders), more than we reward those who invest non-billable time to cultivate and build long-term client relationships – work managed (minders).

In a similar manner we reward the volume of work processed over the profitability of that same work. We have partners who log incredibly long hours doing work that if we dared to really analyze its value, would be marginally profitable at best. We focus almost exclusively on short-term revenue such that we compensate the work-horse who generates 2500 billable hours of 'commodity' work more than the attorney who is developing a potentially lucrative new frontier practice where the engagements are highly complex, but the client demand is still emerging and the attorney's billable hours barely exceed 1500 hours. Rarely do we ask ourselves who is more valuable to our firm in the long-term.

Finally, irrespective of what we might say, we value those attorneys who are production driven over those who are charged to invest time managing a group and helping each of the group members become even more successful at what they do. Consequently, we get pseudo leaders who at the end of the year tell us, "yeah, I guess this practice group is pretty dysfunctional, but hey, look at my hours!"

SOME PERFORMANCE METRICS WORTH REWARDING

There is a philosophy regarding compensation nicely articulated in Alfie Kohn's great book Punished by Rewards. Kohn suggests that the best system is to pay people well …then do everything you can to get them to forget about the money. He warns us that any incentive systems can be disastrous, because they can always be gamed (which lawyers love to do). Many believe that any reward system must be judgmental, with nothing that even smacks of a formula. The minute you give lawyers a formula, you give them all permission to ignore anything that's not in the formula. But life is subjective and so is partner performance. It cannot be reduced to a simple formula. So, with respect to specific performance measures, here are six factors that a firm should identify, track and measure:

1. Profitability

Your primary goal should be to inspire profitable performance and we've already reviewed that in detail in the first two articles of this series. However, in addition and as a signal to discourage your attorneys from simply chalking up hours, consider setting a ceiling such that it is clearly understood that no additional compensation will be paid any attorney who exceeds that ceiling. Such an action will also send a clear signal that time invested in other important activities like mentoring, business development and personal skill building will be considered value at compensation time.

2. Client satisfaction

Using a specific questionnaire or client feedback interview, survey every client at the end of every major transaction or lawsuit.. Survey each client annually person. And (here's the key point) every three months publish the average client satisfaction scores for each group within the firm to all lawyers in your entire firm – high or low. In that way, everyone can easily see which groups are stellar and which groups are less so at serving their clients.

3. Systematic evaluations of quality

There are two levels upon which you might internally evaluate the work quality being delivered to clients – first by determining whether there is proper delegation and supervision on engagements and secondly, by whether there is career-building and people development feedback provided for those working on the engagement at the conclusion of the matter.

Here again, you should have every group or client team rate the responsible partners effectiveness as both an engagement manager (does this partner delegate and supervise work effectively?) and as a people developer (does this partner provide feedback that allows me to learn and do a better job on the next assignment?) You could then publish the results to everybody in the firm so that all can see who is judged to be effective at delivering quality.

4. Contribution to business development

This is an important factor and should purposely NOT be quantified so that joint marketing can be encouraged, and activities like seminars, speeches and articles can be recognized.

5. Personal skill development

The question within the group becomes: Is this professional working to develop and build their knowledge, their substantive skills, and make themselves more valuable and special (read that to mean: meaningfully differentiated) to their clients? The question for each individual member to reflect upon is: What is it that I can meaningful do and contribute to enhance value for my clients now, that I couldn't do for them a year ago? And if your personal answer is zilch, then I think we have a problem.

6. Contribution to the success of others

These contributions should also be judged by your peers and could include recognizing individual team members who contribute value, who follow through on executing their projects for the team, and who come to the aid of others, above and beyond the call of duty. It should include recognizing those who make substantive contributions to the firm's knowledge bank and help the group avoid reinventing the wheel in serving clients. It is useful to utilize three -year moving averages on all of these performance metrics, so that you cannot obtain the full reward for top performance until it has been demonstrated for three years.

What weight should you give to these factors? As indicated earlier, you should work very hard to say: "there are NO weights." No portion of compensation can be "locked in" by doing well on any subset. You've got to do well on all. You judge the whole professional and the full range of performance in deciding whether high or low compensation is deserved.

Having said all that, many prefer systems based on points or share of the coming year's profits. That way, in any given year, the only way for someone to get more cash is to improve their particular practice group's performance or firm-wide results.

As you explore this issue of compensation without relying on billable hours, remember that you need to involve everyone in the diagnosis and design—get their input. Involvement is absolutely essential. We often say, "no involvement, no commitment." AND, keep it simple. It's quite easy to make any compensation system more complicated than it needs to be.

The Partnership Track: A Blind Race

At the beginning of one's career, one sets upon a course of being a "good soldier", doing what the system asks of you in the profession's self described "tournament" style search for excellence. You must perform better than others so that you may advance within the organization. A large measure of blind faith is involved in doing this (which is amazing considering the cynical nature of most lawyers)[note—or maybe it shows cynicism is borne of age!] because the standards of what it takes to be successful as defined by each firm are not usually communicated clearly or applied evenly – perhaps because they may be neither particularly well-defined nor politically correct in the first place. For the participants, the perception, and all too often the reality, is not so much that they are participating in a rigorously monitored and graded competition, but running a race in a fog with no lanes, no finish lines, no judges and no spectators.

Given industry average attrition rates for associates of about 20% per year and eight to ten year track to partnership, the probability of attaining partnership is poor for those enlisting in the competition. This system renders the cost of advancing the few who survive the ordeal prohibitive. How does a system work at all, let alone efficiently, by hiring the best and brightest talent available from the most prestigious law schools, paying premier salary and benefits packages, and then going through them like tissues in flu season? The cost to the organization is multiples greater than the returns possible from the few that succeed. This cannot be the real purpose…….so what is the real story? Maybe the system isn't about a reward for being the "best of the best" after all. Maybe its portrayal as a tournament, should be revised as a game that has few winners, and which clients subsidize with unnecessarily high fees and costs. A game that drives many of the best and brightest out of the profession by consuming them on a treadmill of relatively meaningless work, and severely limited prospects of advancement. The soylent green wafers the system consumes for nutrition aren't made from plankton after all.

Few partners are made relative to the numbers hired from law school, and fewer still are home grown. In many firms the number of lateral partners admitted over the past ten 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. And it is a component of why life for many partners, especially those in the lower two thirds of the partnership ranks, and all associates, has become increasingly pressured and perceived as out of balance with a life style that is worth living. Ever increasing billable hours quotas, and higher billing rates to be pushed upon their clients are demanded of them by their leaderships. Political fear and oppression of contrary views of how firms should be run or their client relationships serviced becomes commonplace. "Get with the program or get out" is the message. There is not much ambiguity there. Nor are there many alternative choices to move to other firms in which the mantra is any different.

A not uncommon phenomenon is the partner who trains and works his protégés up to the level of finally becoming a potential success as a stand-alone partner – and therefore a competitor for the mentor. So, in this Hobbesian world, the protégé is counseled out before they have a meaningful relationship directly with any client of the partner, during a career in which they have been actively discouraged from developing their own independent client base. Senior partner "mentors" become sovereigns who "eat their young". Why do they do it? Because more equity partners potentially take away from the profit pie, creating competition in the area that the senior partner is most expert. Better to toss the juniors out and bring up another youngster until they reach the same level, repeating the cycle over and over.

This process repeats itself because it generates more money for the senior partners, and consumes and eliminates potential competition. Hundreds of thousands of dollars of sunk costs for recruitment, training and mentoring is lost with every associate and junior partner so terminated. (A firm with 300 associates that loses sixty of them in any given year, loses Fifteen to Eighteen Million Dollars of otherwise net distributable income, perhaps as much as ten percent of the amount of total net income to the firm. That translates to roughly $80,000 to $120,000 per year per partner). Those are dollars that come from clients, and internally from the lower tiers of partners from income allocations. No other profession consumes its own people with such a voracious and wasteful appetite. A firm that refocuses its approach upon delivering value, through hiring a select number of people, and making every effort it can to invest in and retain as many of those people as it can, both in terms of skill development, and compensation sharing that supports collaboration and fair value to all of the members of the team, and to the stability of the business enterprise, will have an enormous competitive cost advantage over the present leveraged model that prevails. This advantage will not only be through the reduced turnover cost highlighted above, but in reduced operations expenses for rent, computers, lower recruiting costs and smaller classes of more selective hires.

Mention has been made recently of the jettisoning of the lockstep compensation model for associates as a positive move to bring "reality" to the cost structure of firms. This ignores the fact that merit based compensation and promotion was the model before lockstep was adopted by big law firms. The problem was that partners did not put the time and effort into merit evaluation to make it meaningful, and exercise of power by partners did more to assure that "favorites" were promoted over more capable and deserving candidates. Returning to a system that firms couldn't make work before is not necessarily cause for rejoicing, nor any assurance that it will in fact reduce costs to clients. The bigger problem with the model is the cost of the rollover of so many attorneys at such great cost.

What about the model of the big law firm? There is nothing inherently superior about the model of the big firm, though it could be inherently more profitable if it leveraged experience and prior work product instead of hours. As the the current recession has shown, the big firm model is not more profitable: the global firms have had a harder time maintaining profitability. While the big firm model could be inherently more stable if it focused on talent development and succession planning, it does not; multiple failures of NLJ 250 firms over the past year belie this suspicion. While it could foster inherently better quality work or "seamless" delivery of legal service through robust quality control and processes; it has not as virtually any client will attest. Bigger is just that….bigger – not better. Its advantage to clients may be incidental, as contrasted to its real benefit of size, and leverage to some of the partners, which delivers more profit in good times. In bad times it is reflected by the termination of those least responsible for the compression on profits, the associates, junior partners, and staff personnel. None of which would seem to be addressed to providing better quality work at lower prices for clients.

Do we need big law firms? Absolutely, and there will be a large and robust practice arena for them into the forseeable future. Do we need "those types" of law firms, of any size, that derive substantial amounts of their distributable partner income from inefficiently consuming their own human resources? It is hard to believe that it is necessary or desirable. The new model has to change its compensation structure to incent behaviors significantly lacking in most large firms today.

That compensation model should focus on the long term strengthening of the institution of the firm over the short term remuneration to the partners. Reduce use of short term debt for working capital as by at least fifty percent compared to recent years, increase partner capital requirements to 100% of annual compensation, maintain larger balances of cash for operating reserves (60 days would be a good start), restrict payouts of departing or retiring partner capital to an intermediate term of 5 to 7 years, such that there is a major incentive to be a part of a firm that has strong prospects of long term survival, require limits to compensation and service terms of leaders and managers, include attorneys from the first year of associate status in profit sharing at a minimum scheduled level of 20% of compensation based on budget, and hold practice group leaders and other senior managing partners financially accountable for failure to meet budgets by having the first 20% of their income applied to results below initial budget before their partners bear the outcome. With authority should come accountability. With results should come benefits, and burdens. The rest will work itself out.