

At a “Compensation ThinkTank” I attended at the end of January in New York with some 50 firm leaders, one of my fellow speakers spoke eloquently and presented insightful statistics on the degree of excess capacity, stagnant demand

and suicidal pricing pressures that firms are currently facing. At the conclusion of his talk he offered “a five-step program for your partners.”

His five steps consisted of:

- **DENIAL:** Snap out of it; understand the world has changed. We’re not all going back to 2006;
- **ANGER:** Is fruitless. Your clients have done nothing wrong;
- **BARGAINING:** With the managing partner, the compensation committee, and your friendly local headhunter will get you nowhere;
- **DEPRESSION:** Let us know when you feel like behaving as an adult again; and
- **ACCEPTANCE:** You’ve had an insanely great 25-year run, how about a little gratitude?

When the request for questions arose, I could not contain myself from offering an observation: *These five steps all assume one thing – that when dealing with your partners on money issues, you are dealing with RATIONAL people! I would respectfully submit that that may NOT always be the case.*

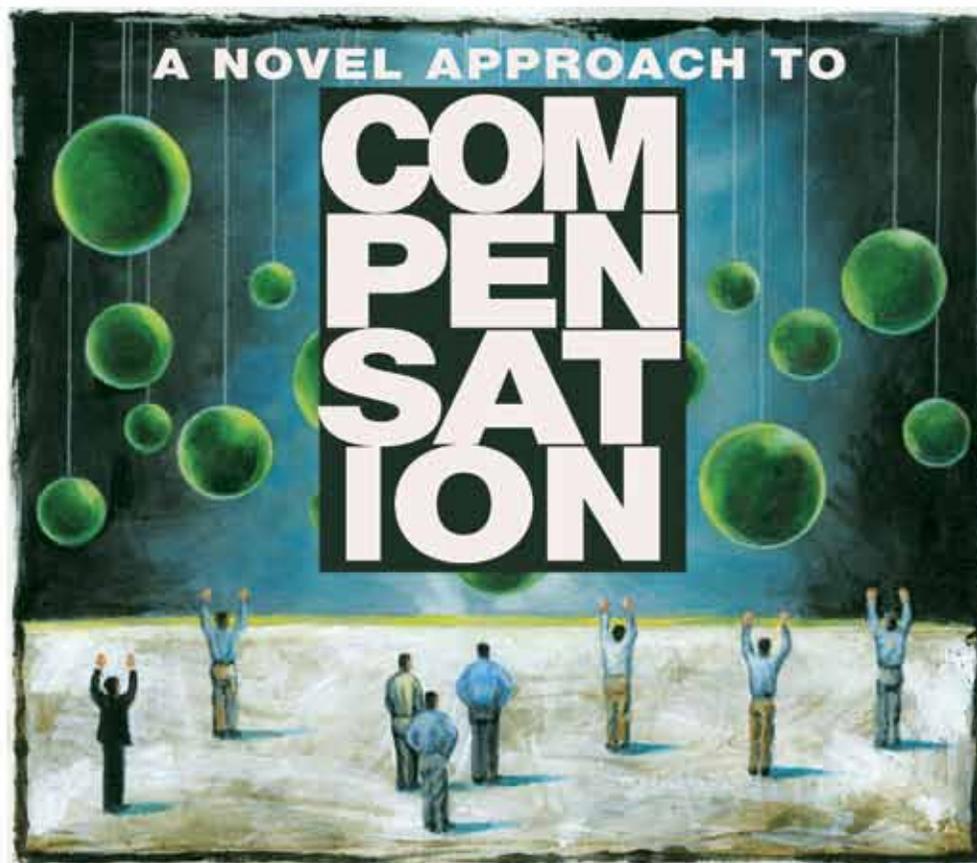


EXHIBIT ONE.

At a time when many firms concluded 2013 with flat revenues (at best) and fairly flat profitability, one of the common stories that I’m hearing from managing partners is about having to confront the partner with the big book of business who wants more money this year.

When told that the firm’s revenues and profits are flat and indeed that even this partner’s billings and performance are on only par with last year, the response the firm leader gets is that the partner still feels they deserve more. When asked why they feel that way given the facts, the demanding partner informs you that their book of business is obviously **worth even more** to the firm now than it was last year.

“**W**e’ve created a reward system that empowers group leaders, and we’ve structured compensation in such a way that everyone has a reason to be more bottom-line oriented, and more conscious of cost efficiency; than is usually the case at most law firms.”

EXHIBIT TWO.

Conventional wisdom, as well as economic theory, tells us that the more of something we have, the less of it we want . . . but that is not the case with money! According to some brand new research released in January by Jeffrey Pfeffer (professor of organizational behavior at Stanford’s Business School), money earned through our individual labors is more important to us than money that comes from other sources like investments. And the more money paid for each hour of work, the more important that money becomes.

According to Jeffrey’s research paper, “*When Does Money Make Money More Important*” money is like an addictive substance in that it raises the bar and leaves people always wanting more. We generally believe that our compensation communicates our

self-worth. The higher the compensation, the **more importance** the person places on money.

Now I don't know what the answer is and we certainly did not get any magic bullets from the five steps suggested above, but it would seem that leaders who focus on money as THE reward are going to have to give more and more of it to have any motivational impact. So perhaps it's time to explore some innovative alternatives to the ways in which we have traditionally approached partner compensation.

On that note, what follows is a discussion with one AmLaw managing partner (who will remain anonymous) who has taken a completely different route from most other firms. The transcript of this discussion is provided *only* to stimulate your thoughts about how we have usually approached partner compensation in many firms.

Question: Tell us about how you have approached partner compensation?

I think it was a combination of luck, remarkable support by the firm's principals, and fundamental institutional changes within the firm. Turning the departments into practice groups was a crucial first step. But even more important than creating the groups were the steps we took to empower the group leaders and especially, to encourage a focus on the bottom line.

Key elements have included a great emphasis on delivering client service responsively and efficiently. But a lot of firms at least pay lip service in that area. So I think that there has been another major contributor. That is the firm's unique compensation scheme that directly affects the practice groups as groups. **Both bonuses and equity participation are determined substantially by group performance.**

We've created a reward system that empowers group leaders, and we've structured compensation in such a way that everyone has a reason to be more bottom-line oriented, and more conscious of cost efficiency, than is usually the case at most law firms. And it's all based on the practice group, which is the fundamental entity for delivering and developing legal services. They must be self-managed.

Question: What kind of behavior does your compensation system encourage, and how does it do that?

Let me begin by fessing up to one thing: no system devised by mere mortals can work flawlessly to encourage only good behavior. We are talking about incremental change facilitated by a system that still needs an overlay of management judgment and flexibility. Lawyers are still lawyers; they tend to react to any system by seeking out the wrinkles that advantage themselves most directly. But having said that, the system is designed to discourage the worst excesses of the self-aggrandizing "stars" and to cause a focus on group performance, specifically, including the group's bottom line.

As is well known, at many law firms a partner gets paid for the revenues off a book of business, end of story. Some major rainmakers may be tempted to extort the money. Pay me x because the United World Enterprises is my client, and if you don't pay me, I'm going to another law firm and taking it with me.

Unpleasant as that is, it might still be a logical way to run a business if that partner were actually helping the firm. But here, and, I imagine at other firms as well, we were actually losing money on some of our rainmakers. For example, the first time we looked at group and office profitability we learned that the unit in the firm which had three of our top four billers was our only unit losing money! Why? Because a system of awarding "stars" based primarily on their revenues did not encourage these capable lawyers to be concerned about the success of others in their group. The others were effectively their "competitors" instead of potential contributors who could benefit from some mentoring.

So we started profitability analyses on a practice group and office basis and we allocated compensation in part on the results.

Question: How could you get away with it? At most firms, you'd have been hung out to dry, or the guys with the big books would have left. Your revenues would then have plummeted, not increased as yours have.

I was in a more fortunate position than my predecessors. When I took the job, the principals were committed to the idea that great deference should be given to the CEO's decisions, who could be removed if over time they turned out to be ill-advised. By the time I came up with a new compensation scheme, there was a clear recognition that significant change was needed. There was limited opposition.

Previously, we hadn't even looked at unit profitability. In fact, our failure to understand which of our units were profitable was itself divisive because the absence of objective data certainly didn't prevent finger pointing based on myth and rumor when things weren't going well. The new system has the benefit of eliminating griping by some units that they're "carrying" other units. The data showed often that their gripes were completely unfounded.

And there was a related benefit. Once we allocated compensation to groups based on the group performance, we could **empower the group leader to allocate that compensation to the members of the group** rather than have compensation allocated by an independent compensation committee, the system previously in place. Of course, without the discipline of a group's compensation pool being based on its productivity, it would be impractical to allow group leaders to determine compensation. They would always seek to maximize the compensation of their own group's members at the expense of other groups. Someone would have to referee the wrestling match.

That "someone" for us was an independent compensation committee whose

members were usually not in firm management positions. I think a lot of firms operate this way. But there are a lot of problems with an independent committee, particularly in a fairly large multi-office firm like ours. It is difficult for the committee members to really know of the various contributions of all of the attorneys in the firm. So they're forced to rely on data and things like self-evaluations. This leads to a lot of self-promotion and decisions by hearsay. It also denies the practice group leaders one of their most effective tools: the ability to assure the members of their group that their actions, for better or for worse, will be recognized by the group leader. Finally, with a separate committee, compensation decisions may not reflect, or may actually be contrary to, the goals of management.

So we went out and did the opposite.

Question: And who determines how much the practice group leader gets paid?

He or she determines what he or she gets paid.

Question: That is unique! How can you ensure that something like that will be fair?

The extraordinary fact of the matter is that most of the decisions over the years have been just about on target from my viewpoint. The group leaders don't want to lose credibility with their people. They realize that they have to practice what they preach. If a group is doing well, the members of the group do not begrudge the leader's compensation. Conversely, if a group is not doing well, the group leader must use the group's limited funds to fairly reward those in the group who are performing.

It certainly sharpens the concentration of everyone in the group on the subject of how well the group is performing! I rarely, if ever, see a group leader paying him- or herself too much. I have seen group leaders, in the interest of effective leadership take less than their fair share.

Question: How is the total pool of dollars for each practice group determined?

We have a sophisticated system to determine revenues and expenses for each group and office. Central costs, like accounting and information systems, are allocated pro rata, and actual costs attributable to a group, like salaries and practice development expenses, are allocated accordingly. Revenue is based on dollars collected, not billed, and there's a special twist.

We base revenues on a composite number which is roughly designed to reward the four basic roles which a lawyer performs in generating firm revenue: originating work; supervising work; client responsibility (or billing); and, last but not least, performing work.

The groups' composite revenues are the combined composite revenues of its

members. The composite revenue for an individual is composed or weighted as follows: 65 percent from the individual's working revenues; 25 percent from the individual's origination revenues; 5 percent from the individual's matter-supervising revenues; and 5 percent from the individual's client billing numbers.

Question: Voila, a profitability determination! How then is compensation related to that determination?

Fifteen percent of each principal's share of firm profits is put into a bonus pool. That pool is allocated among the practice groups in two ways. One half, or 7.5 percent of firm revenues, is automatically allocated back to the group in accordance with its members' contribution to the pool. Remember, one half of the individual's contribution is not allocated back to the individual, but to the group for allocation among its members by the leader.

The other 7.5 percent is distributed among the groups in accordance with their profitability. A group must reach a certain level of profitability to receive any of this 7.5 percent. The most profitable groups benefit accordingly.

It's worked so well that I call it the "7.5 percent solution." The allocation of this relatively small percentage of firm income on the basis of profitability has caused groups and offices to pay keen attention to the bottom line. That under-utilized paralegal that nobody used to care about is suddenly either utilized or gone.

And the effect on associate management, which is such a problem profession-wide, is most salutary. Half of first-year compensation is charged to the group and three-quarters of second year compensation. By the third year, however, the practice group pays for the lawyer entirely. So there is a substantial incentive to either mentor an associate to success or outplace them if they are not succeeding. Lawyers are notoriously shy on both counts.

The system also permits the group leader, who is presumably knowledgeable about the non-quantitative contributions of their charges (certainly more than a distant compensation committee), to recognize qualitative contributions. While the group's bonus pool is based on its economic performance, the group leader is free to allocate among members of the group on the basis of other factors. The group leader can reward someone whose billables are low for some reason, or who hasn't developed a major new client, if that lawyer has, in whatever other way, made a great contribution to the group.

Question: You said before that equity distribution is also determined at the practice group level. That seems to be a particularly significant development.

A principal's share of firm profits (or "step level") is determined every two years. Again, this share is determined by reference to the group's performance. We look at a group's average step level and compare it to the net income generated

by the average principal at that step level. If the firm average principal at that step level generated more net income, then the group is “over-stepped” and we reduce its total steps by one half of the reduction necessary to bring its average steps in line with its net income.

The adjustment is only one-half because we realize that economic performance is cyclical and we are not an ‘eat what you kill’ firm, even by groups. Similarly, if the group’s performance is better than its average step, the group is “under-stepped” and one half of the steps necessary to bring it in line with its performance is allocated to the group.

The steps (or shares of profit) are then allocated among the group members by the group leaders in accordance with their evaluation of relative contribution. Again, the compensation committee oversees this process, but by and large it defers to the judgment of the group leaders.

Question: The group leader determines the equity status of the partners in his or her own group? And the group leader then allocates his or her own points as well?

Yes.

Question: Your firm may have the most powerful practice group leaders in the profession.

Maybe.

Question: I understand the incentive strategy here, as well as the unique empowerment your practice group leaders enjoy by having their hands on the lever come payday. But isn't there a concomitant danger of too much competition between practice groups as they struggle for larger and larger shares of that 7.5 percent?

Absolutely. This is something that presents a continuing challenge. To some degree, we’ve shifted the maneuvering among individuals to maneuvering among groups. But we encourage cooperation among groups in at least three ways: One: Exhortation and appeals to enlightened self-interest (since at least 92 percent of the revenues of any group become firm income to be shared in accordance with the groups’ relative points).

Two: An annual anonymous survey designed to elicit commendations for cooperation and examples of non-cooperation, followed by special bonuses for the good examples.

Three: The origination portion of the composite number automatically encourages collaboration and cross-marketing.

The conflict point is when we open a file, because that’s when we determine how we allocate that file’s revenues among principals. Working and, generally, matter-

supervision present few problems, of course, because it’s obvious who’s doing what. But billing supervision can present a problem, because some clients are very particular about how they get billed, and lawyers who originate their business or supervise their matters or log the hours may not be the ones to entrust with the billing.

And, of course, origination is always a minefield, no matter how you look at it, because it’s hard to determine who did what and who should get the glory. But we allow the 25 percent origination credit to be shared among up to five people, so in the vast majority of cases these issues are resolved without dispute or my intervention.

Theoretically, you could also have a situation where a group is so busy, and so profitable, that it won’t take on work referred by another group unless it gets what amounts to a premium, such as the credit for origination. Generally, though, the system produces civility. It’s in everybody’s interest to collaborate because, obviously, it adds to their own origination credits when they do.

Question: Doesn't your system mitigate against healthy, even necessary levels of risk in the sense that revenues could go down, or costs could go up, if a practice group is charting some new practice specialty or exploring some new industry target?

All significant practice development effort requires a reasoned risk/reward judgment, whether by the firm, the practice group, or an individual. I would like to think that the system does not stifle initiative but, rather, encourages prudence and a wise allocation of resources. We can also make “equity adjustments” to the compensation pools and award administrative bonuses for contributions that benefit the firm at large rather than a particular group.

Question: How did you come up with this whole idea? You seem to think more in terms of group dynamics than most managing partners, and more in terms of collective action and collective incentives.

Actually, if I do think a lot in terms of groups. It may simply be because of my own sense, when I was running one of our offices, that the power of positive group dynamics was undervalued. From that experience, I began to naturally think more about incentives in general, and how incentives work and should work.

The problem is, for lawyers, words are action. Lawyers make their living uttering or writing words; that’s their stock in trade. But in management, action is action, and you have to overcome the tendency, reinforced by years of education and training, of most lawyers to substitute words for action..

My challenge, therefore, is to get the practice groups to do something!

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