



# PARTNER

## Compensation Systems

IN PROFESSIONAL SERVICE FIRMS

# Partner Compensation

## SYSTEMS USED IN PROFESSIONAL SERVICES FIRMS

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*Before you overhaul 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. 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 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

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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 than 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 a 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 there 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 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 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.

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

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- 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 know 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 than 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.

### 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

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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 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 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.

### 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

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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.

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