EDGE INTERNATIONAL

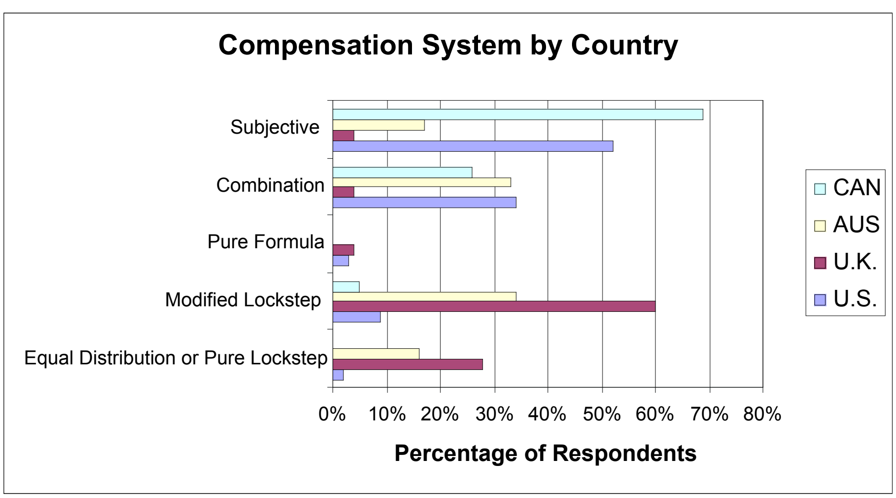
Do Law Firm Compensation Systems Drive Profitability?

We are often asked by firms if one form of compensation system is more likely to enhance profitability than another. Our impression, based on anecdotal evidence through our work with law firm compensation plans caused us to believe that highly statistically driven systems hurt firm's profits. Now we have evidence that this is true.

We have conducted the most comprehensive survey of large law firm partner remuneration systems ever completed involving 175 large law firms in the United States, the United Kingdom, Canada and Australia.

Among the primary findings was that large law firms with the highest profitability in the United States tend to base their compensation system on more subjective factors than firms with lower profitability. Of law firms responding to the survey with profits per partner higher than $700,000, 75% described their compensation system as being "subjective" while only 21% of firms with profits per partner of less than $300,000 use a subjective system. Conversely, firms with profitability of less than $300,000 per partner were more likely (69%) to have a compensation system based on a pure formula or a formula adjusted with some subjectivity than firms with profits of more than $700,000 (15%).

An obvious question is whether the compensation system drives profitability or the level of profitability determines the method of compensation. It seems to be a bit of a vicious circle. Law firms with fewer dollars to divide among the partners feel that they can't reward subjective factors such as partners who are good at training associates, supporting firm initiatives and providing outstanding client service. But without partner support of those programs the firms can never raise their level of profitability.

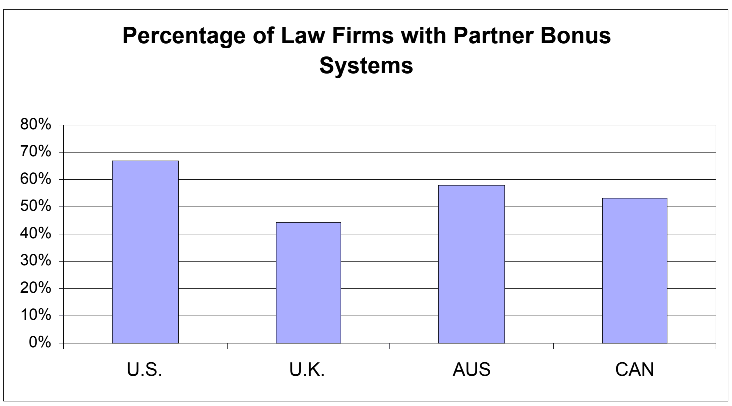


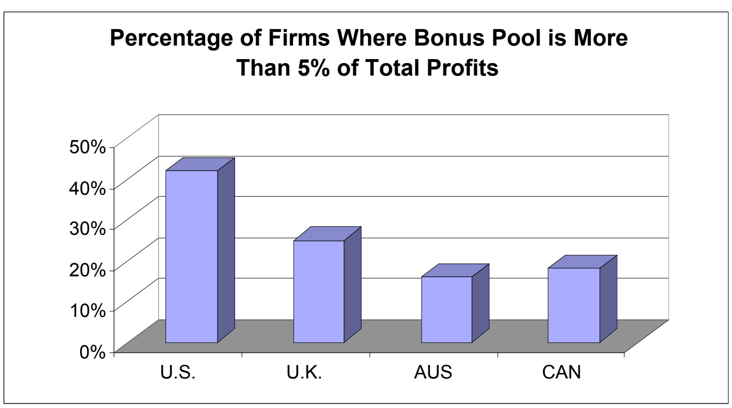
The survey also found a strong difference in the type of systems preferred in various countries. The United States strongly (86%) prefers subjective systems where statistical performance or seniority are adjusted by subjective judgmental considerations. United Kingdom firms, however, overwhelmingly (88%) use "lockstep" or "modified lockstep" systems that emphasize seniority as the primary criteria for compensation and there is little room for subjectivity. Australia is equally divided between lockstep or modified lockstep and subjective or combination systems. Canada favors subjectivity even more heavily than the U.S. (95%).

In working with firms in both countries, we see the difference between the U.S. and U.K. systems as largely being a matter of trust. The UK's dependence on lockstep displays the partners trust in each other to perform up to the firm's standards since there is limited opportunity to make adjustments to the system to correct for deviations from expected performance. In the U.S. the situation is reversed and partners must have more faith in the firm to treat them fairly since their compensation is set through subjective decisions that they have little control over.

Partner Bonuses

Bonuses for equity partners to adjust for single year performance surges and to provide more immediate gratification for successes continue to become more popular around the world. But, as shown below, the size of the amount of profits allocated for bonus is almost twice as large for U.S. firms than their UK, Australian or Canadian counterparts.





Reevaluation of Partnership Units

Overwhelmingly, law firms, in all four countries reconsider their individual allocation of profits annually. The frequency by country (excluding lockstep firms) is:

	U.S.	U.K.	AUS	CAN
Annually	77%	76%	83%	95%
Biannually	11%	8%		5%
Other	12%	16%	17%	

Non-equity Partners

Non-equity partnerships (partners who are paid on some basis other than a percentage of profits and who typically are not considered owners of the firm) continues to grow in most countries. As shown below, they are even more popular in the UK and Australia than they are in North America.

	U.S.	U.K.	AUS	CAN
Only for Associates Entering the Partnership	1%			
Only for Lateral Entry Partners	2%			
For both Associates and Lateral Entry Partners	74%	92%	100%	58%
Non-equity Partnerships Not Used	23%	8%		42%

Conclusion

Law firms with profitability problems are constantly looking for a quick fix – a silver bullet that will cause them to be more profitable without any effort by the firm. It's natural that they would look to their compensation system as being the primary motivation and reward system to drive changes in profitability. In truth, the firm needs to value such things as working as a team, sharing work, training associates and continually developing individual and practice capabilities. When those things happen it is natural that a firm will gravitate toward a compensation system capable of recognizing and rewarding appropriate contributions. And that really can only occur in a subjective system.