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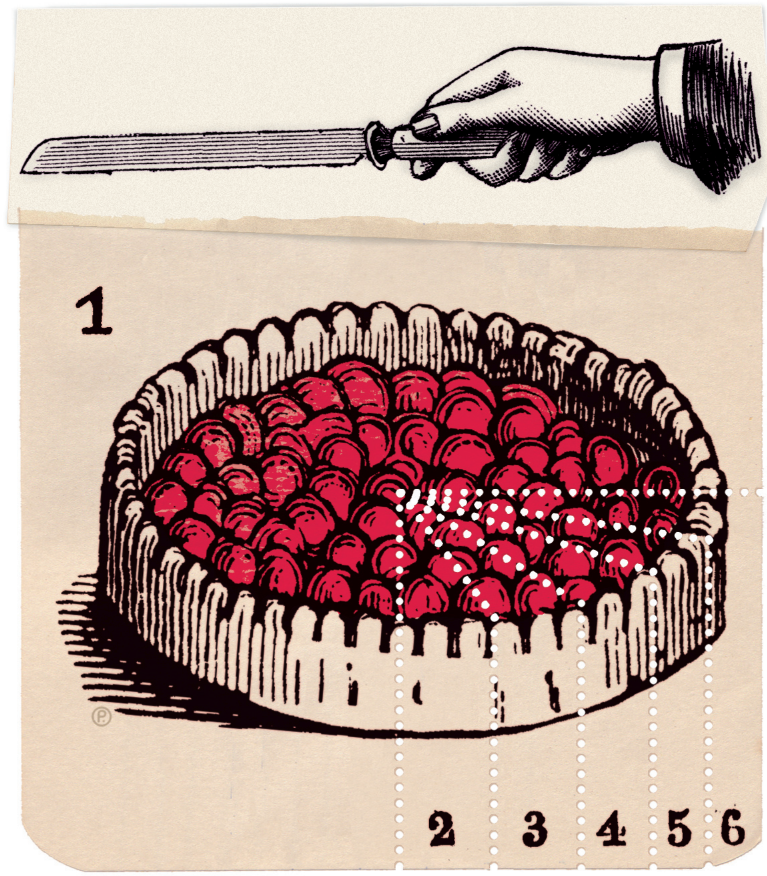
Sliced Too Thin

Often viewed as a shortcut to success, wide disparities in pay, like those at Dewey & LeBoeuf, are instead destabilizing firms.



As firms scour the market to attract laterals with large, portable books of business, they have become more willing to offer almost anything—special considerations, huge compensation, guarantees, and bonuses—to lure them. In our article ["Crazy Like a Fox," February], we noted with concern that the spread from lowest-to-highest partner incomes at some firms has increased to 10:1 or 12:1, and even 20:1. To reward top producers, we wrote, some firms had begun reducing the compensation of lower- and middle-tier partners, even when they had met or exceeded budgeted targets for client originations, hours worked, and hours billed.

This is a dangerous development. As shown by Dewey & LeBoeuf's woes, widening compensation spreads can destabilize firms. Here's how:

■ **WIDENING SPREADS FRUSTRATE THE DEVELOPMENT OF EFFECTIVE PRACTICE GROUPS.** For most firms, attracting laterals is a top strategic priority. Often, improving operational results by adopting a practice group structure is another. Compensation systems that create huge spreads between the highest and lowest performers or focus on individual contributions can inadvertently weaken practice groups. Partners ask themselves: Why should I spend nonbillable time meeting or working as a group when only individual efforts are being measured and compensated?

Various studies suggest that such behavior may eventually contribute to instability. For instance, data from a study of college and university faculty groups conducted by Stanford University Graduate School of Business professor Jeffrey Pfeffer shows that the greater the level of salary dispersion, the less likely faculty members were to work on research with others from the same department, and the lower the level of research productivity. (Individual group members' job satisfaction levels were lower too.)

Pfeffer's research shows that paying high performers significantly more than low performers gets results—when these individuals are working solo. But in situations where individuals are required to collaborate with peers, wide disparities in compensation often weaken trust among team members and strain the social connections that contribute to strong group performance.

■ **LARGE DISPARITIES IN COMPENSATION TEND TO ALIENATE STARS AS WELL AS NEAR-STARS.** Here's a familiar scenario: Firm management, perhaps unconsciously, becomes blinded by a potential lateral's

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status, overpays to sign her, and then showers her with praise and attention. The firm is perceived as providing more resources to the outsider than to homegrown partners, even when both have comparable books of business. Partners begin to resent the lateral (and her pay), avoid her, cut off information to her, and—almost imperceptibly—refuse to cooperate or collaborate.

The arrival of a high-flyer can result in interpersonal conflicts and break down communications within the practice group, so much so that performance suffers. Partners feel alienated and disconnected from the firm, and up-and-comers can become antsy when they believe that newcomers are treated preferentially. When that happens, widening compensation spreads foster tension, damage morale, impair partners' trust in management, quietly eat away at the internal partnership ethos, and poison any sense of meaningful collaboration.

> At many firms with wide compensation spreads, even partners who earn more than the firm's average PPP are being leveraged.

ONCE LURED BY HIGH PAY, LATERALS OFTEN FAIL TO PERFORM AS EXPECTED. We were struck by the recent research of Mark Brandon at Motive Legal in the United Kingdom, which showed that nearly a third of lateral hires into London law offices had failed within five years. Brandon studied 2,295 hires into U.K., U.S., and merged U.S.–U.K. firms in London from 2005 to 2011. Of those hires, 714 (31 percent) had already left the firms they were hired into. That attrition rate represents only the out-and-out failures; behind the figures lurk a raft of other hires who have failed to meet expectations but who have not performed poorly enough to warrant dismissal. The 31 percent is just a six-year average. When Brandon looked at individual years to determine how long partners were lasting, the picture was even more bleak. Among partners hired in 2007, more than 50 percent had already left.

The most surprising finding of Brandon's research relates to team hires. The acquisition of multipartner teams has become many firms' stated preference with regard to lateral partner hiring. The idea is that a team is more likely to bring along clients successfully, is less reliant on a single individual, and will be a more solid hire for the firm. However, the study shows that team hires are no more likely to succeed, statistically speaking, than individual hires.

Meanwhile, the research of Harvard Business School's Boris Groysberg (*Chasing Stars: The Myth of Talent and the Portability of Performance*) shows that too many top performers quickly fade when they change firms and often underestimate the degree to which their past success depended upon such firm-specific factors as long-term working relationships, quality of resources and support, and informal systems through which professionals obtain information and get work accomplished.

Moreover, some lawyers are simply serial movers: Once they start changing firms, they keep moving to the highest bidder. Many stars don't stay with firms for long, despite the astronomical compensation packages that firms pay to lure them.

WIDENING COMPENSATION SPREADS INDUCE MID- TO LOWER-LEVEL PARTNERS TO LEAVE. A firm's profits per partner figure is an average—an arithmetic mean. But it doesn't say anything about a more salient figure: *median* profits per partner, which wide compensation spreads can distort to unsustainable levels. This can be demonstrated by looking at two hypotheticals.

Imagine first an unrealistically simple scenario—a 600-lawyer firm with 150 equity partners, 150 income partners, and 300 associates. The firm has gross revenues of $480 million ($800,000 revenue per lawyer), with net operating income of 32 percent ($153.6 million), which we will treat as fully distributable.

In this scenario, the compensation spread is 1:1—all 150 equity partners, irrespective of their contribution in hours, client billings, and administrative service, receive equal compensation. Everyone earns the same: $1.024 million (the net divided by 150 equity partners). Profits per partner, the arithmetic average of net divided by 150 equity partners, is $1.024 million, and that's also the median.

Now consider a more complex (and realistic) scenario. The firm still has gross revenue of $480 million, 32 percent of which goes to net. The firm's equity partner compensation spread is 15:1, with the lowest-paid equity partner receiving one-half of the average PPP. Suppose only one partner is compensated at 15:1, two partners at 12:1, three partners at 8:1, four partners at 5:1, five partners at 3:1, and 15 partners at 2:1. Average PPP is still $1.024 million. Fifteen partners (10 percent of the total equity partnership) earn more than the average PPP. Taken together, those 15 partners receive 33 percent of the net (about $50.076 million).

Now let's broaden the picture to include 15 partners who are compensated at exactly the average PPP. That gives us 30 partners (20 percent of the equity partnership) who are at or above the average PPP. Together, they receive $65.536 million (42.7 percent of net). The highest-paid partner receives a multiple of 7.5 times average PPP, which is as much as all of the partners combined in the category of those who earn three times average PPP, and half as much as the entire group of 15 partners that makes the average PPP.

What must happen to the rest of the partnership structure to achieve this result? The remaining 120 equity partners share in $88.064 million, an average of $733,866 each. The average PPP is still $1.024 million, yet 80 percent of the partners make less than that.

Now consider firm operating costs, which are allocated on a per-partner basis. Overall, they are $326.4 million (68 percent of gross revenue), which works out to roughly $217,600 per partner. Suppose equity partner Mary is billing 1,750 hours at $650 per hour with a 92 percent collection realization. Over the course of a year, she will generate $1.0455 million. Subtract her overhead allocation ($217,600), and $827,900 remains.

If Mary is compensated less than $827,900, then she receives nothing for the client business she delivers to the firm and nothing for the enterprise profit from the fee earners who are not equity partners. She contributes profit from her labor upstream, to the partners who earn more than the average. In this hypothetical firm, considerably more than half the equity partners, probably 60–66 percent, are in this category. Almost two-thirds of the equity partners in the firm are leveraged. Equity partners might expect associates and nonequity partners to be included in the pool of workers from whom profit is leveraged. But do they think of themselves as leveraged? Probably not.

The wide compensation spread at Mary's firm gives her a financial incentive to leave her firm, to seek out a firm where she can make more money by reducing operating costs, while working fewer hours and cutting her billing rates and fees to clients.

Let's say she moves to a smaller firm, takes $2 million of her $3 million client base, drops her hourly rate to $500, and bills 1,600 hours a year. That generates gross revenue of $736,000 (after 92 percent realization) and leaves $1.2 million of the work she brought in (billed at $350 per hour, for 3,428 hours) to be performed by contract attorneys or associates at an average weighted cost of $150 per hour. Conservatively, that work could be expected to result in a profit of $685,714. She has rent, supplies, insurance, staff, and other overhead expenses of $100,000–$150,000. The net enterprise profit for a smaller book of business in the new model is at least $500,000, by my conservative accounting, and the formerly leveraged partner now takes home $1.286 million, instead of $600,000–$800,000 at her old firm.

Given that, how much incentive do partners have to stay put, in an effort to reach the top 10 percent in the prototypical current business model? What incentive does any partner have to stay, without sharing in the enterprise value of the work they deliver? What incentive do clients have to stay, for that matter? There may be clients who need their outside counsel to be part of a larger "platform," but those are easy enough to develop without the cost load and profits allocation formula that pushes rates astronomically high.

At many firms with wide compensation spreads, even the partners who earn more than the firm's average PPP are being leveraged by those above them. Their actual share of enterprise profit is quite low, much lower than the value of their client billings. At what point does a firm like this collapse under the weight of its own stars?

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