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# Is Our Partner Compensation System Working?

As a result of the financial crisis firms have experienced four years of financial results affected by price pressures and depressed demand for legal services. With rigorous expense management and other initiatives many firms have weathered the storm reasonably well. But one aspect of firm management that has become increasingly challenging is the compensation of partners.

Most large law firms base compensation on units or tiers - the value of which is dependent on the total number of units allocated (or partners on each tier) and the firm’s profitability. More sophisticated approaches tend to have mechanisms that encourage partners to focus on overall firm performance (thus driving unit value up) rather than only individual performance.

Determining partner compensation when times are good and nearly everyone is on course to earn more than the year before is relatively straightforward. But as profits have flattened, or even declined, firms have found that problems and tensions have risen.

When the unit value is flat or drops the only way to increase an individual’s compensation is to increase their units. But the greater the total number of units allocated the lower the unit value. This phenomenon tends to hit partners at the top of the scale (where unit increases are less common) more than partners at the bottom or middle where unit increases are more the norm. High performing partners may be willing to accept this for a year or two if they see it as being in the interests of the firm, but there are not many partners who are willing to accept it indefinitely.

Furthermore, the challenges of managing compensation during times of flat profitability are sometimes exacerbated by a difference in perception between management and partners concerning the effectiveness and fairness of the approach.

In our work over the last few years with numerous firms (both national and international) we have seen a number of recurring issues:

- Firms have experienced significant compression in compensation. This occurs when partners at the bottom and middle of the partnership move up the scale, but the partners at the top, who are either capped or face very demanding performance criteria to advance, do not. This can result in a group of partners in the middle who are overcompensated relative to their contributions.
- Some firms have awarded units not for improved performance but to preserve the monetary value of compensation in the light of declining unit values. This has sent mixed messages about what is required to advance in the compensation system.
- Some firms have allowed small differences in compensation to creep in, either by awarding small bonuses, or allocating fractional units or smaller steps than originally anticipated in the compensation design. Small differences in compensation invariably lead to resentment among partners.
- Some firms have distributed the bonus pool to an increasing proportion of partners, thus diminishing its overall value as a differentiator for extraordinary performance.

- Firms have not effectively addressed underperformance issues. Significant underperformance will not be solved by a cut in compensation.
- Firms are not including performance management or performance feedback as part of their overall approach. Lack of direction and feedback can be demotivating for partners who are moving down the compensation scale as well as partners who aren't going up as much as they think they should. In a feedback vacuum partners draw their own conclusions, which are often not consistent with the message management would have sent.

So what have firms done to address the challenges? The specific solutions or approaches that are appropriate for any firm need to be developed as part of an analysis of the firm's partner compensation system in the context of its strategy.

Most are not completely overhauling their approach. They are, however, finding some changes are required in order to restore effectiveness and fairness. A number of initiatives taken by firms that we have been working with include:

- Increasing the size of the bonus pool to provide more flexibility to direct money to the partners who are contributing the most to the firm. This needs to be managed carefully and firms need to avoid the temptation to sprinkle bonuses around to a large number of partners.
- Becoming more disciplined about moving partners down a tier or perhaps more if performance has slipped or flattened. In the past movements down used to be relatively rare and only instigated after a period of sustained (e.g. 5+ years) underperformance. Now it is not unusual to see up to 20% of the partners in a firm moved down in a year.
- Recalibrating the placement of partners in tiers. One firm reduced all partners by one compensation tier to reset the structure and unit values. A very few high performers were then moved back up.
- Modifying the structure of the system to extend the levels at the top tiers, thus stretching the ratio of top to bottom compensation. We see more firms moving to higher ratios of top to bottom compensation, particularly when bonuses are included in the calculation.
- Clarifying the performance expected at key levels on the compensation scale and being disciplined in applying these performance expectations in the evaluation process.
- And, perhaps most significantly, improving the effectiveness and robustness of the partner planning, evaluation and feedback processes.

Of course it is important to ensure that the underlying profitability or strategy of the firm is not the real source of discontent within the partnership. While tweaking the partner compensation approach will not harm in such circumstances it is unlikely to address the fundamental problem and more far reaching changes will be required. Often, however, it is within the compensation system itself – either in its structure or its application – that the shortcomings lie and significant improvements can be achieved.

**London**

Principal: Giles Rubens
giles.rubens@fairfaxassociates.com
44 (0)20 3633 3943

**Washington**

Principal: Lisa Smith
lisa.smith@fairfaxassociates.com
202.365.4180

**California**

Principal: Kristin Stark
kristin.stark@fairfaxassociates.com
415.215.9294