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Mergers: Evaluating and Aligning Partner Compensation Approaches

This month Fairfax Associates hosted our 3rd annual partner compensation program for law firm leaders. The following Insight captures the thinking of Fairfax consultants Lisa Smith and Kristin Stark during a panel discussion about partner compensation in the context of merger discussions.

Compensation provides a lot of clues about a firm's culture, strategy and performance. How do you go about evaluating partner compensation in a merger discussion?

Partner compensation is one of the top five deal breakers in merger discussions, due to differences in 1) compensation philosophy (what the system rewards), 2) compensation setting structure and/or process, 3) compensation decision making bodies, or 4) actual levels of compensation.

Tackling the topic of partner compensation early in the merger discussion process can help firms avoid investing substantial leadership time and energy in a merger that simply won't work. That being said, compensation can also be a difficult and contentious topic, so it does require some level of rapport and trust to be built between firms before a constructive dialogue around solutions can take place.

When we facilitate merger discussions, we recommend that firms explain their partner compensation philosophy, criteria, structure and process at one of the initial exploratory meetings. If no insurmountable differences are identified, and discussions move ahead, then a next step will be to exchange data on individual partner performance statistics and compensation allocations. By exchanging key performance indicators and compensation allocations, firms can assess each other's compensation outcomes to determine whether there is enough similarity to warrant further discussions. Firms often 'slot' the partners of the other firm into their performance data and compensation allocations to determine how similar the two systems are based on a limited set of purely numeric factors. While firms shouldn't expect or seek precise alignment of compensation approaches or outcomes, shared views on criteria and their respective emphasis or valuation of those criteria can be critical to evaluate the long term fit between the firms.

In addition to comparisons of partner performance data and compensation allocations, we see value in other types of analyses – some relatively simple, and others more complex. A simple, early analysis that preserves confidentiality, involves a review of average compensation by decile. This analysis helps to assess the relative spread of compensation among the partnerships. Two firms with very close PPEP may distribute money quite differently among the bottom, middle and top of their compensation tiers. We also often perform a multi-variate regression analysis to test the relationship between stated compensation criteria/factors and actual outcomes. This analysis can uncover substantial differences in compensation approaches, even among firms whose systems appear, on the surface, to share similar philosophies.

What are some red flags to look for that could signal incompatibility?

Unfortunately, there are a number of issues that can turn into deal breakers, particularly when they are seen to be core to a firm's culture. These include:

- **Major differences in compensation system structure:** Merger discussions between a firm with a subjective system and a firm with a formula system often fail due to the difficulty in gaining the trust of partners needed to migrate away from a formula, or the reluctance of a firm on a subjective system to move to a formula. Other examples of structural differences which can be hard to overcome include open vs. closed systems (transparency can be a sacred cow for many firms, and yet, opening a closed system is fraught with challenges), and prospective vs. retrospective systems (firms with retrospective systems can be more focused on short term partner performance, and may be concerned about partners in prospective systems underperforming and being 'overpaid' in that year).

- **Differences in what is valued or the extent to which different contributions are valued:** The most typical examples we see of this include firms that are more heavily focused on personal production than business generation, or vice versa, or firms that don't compensate for leadership.

- **Overly divergent allocations:** When mergers encounter multiple instances of partners with comparable performance metrics, but materially different compensation amounts (with no clear explanations to justify the difference), it can be an indicator of more deeply rooted systemic differences or inconsistencies between the firms.

How often do firms develop a new approach to compensation in the context of merger rather than adopt an existing system of either firm?

We tend to see the adoption of a new combined firm compensation system as part of the merger when the two firms combining are similar in size, or when both firms recognize major limitations in their system and are looking for ways to reconfigure compensation going forward.

Mergers of equals often have a unique challenge in that the systems that work for a 200 or 500 lawyer firm, may not be best for a 400 or 1000 lawyer firm. So even if each firm's system is working relatively well for them, it may not work for the combined firm.

Merger discussions tend to be most successful when firms are not so wedded to their system that they aren't willing to consider at least some amendments.

What are the typical challenges that firms face in dealing with partner compensation in a merger?

Occasionally firms make compromises on partner compensation in order to get a merger completed. However, this creates long term ramifications which can be difficult to reverse. A prime example is the creation of an overly large compensation committee in order to allow leaders/compensation committee members at both firms the opportunity to retain their positions, without planning for a phase out of members to enable the committee to return to a more manageable size at some future point. While involvement of leaders at both predecessor firms in compensation setting can be critical to merger integration and the success of a compensation system, overly large compensation committees can lead to cumbersome compensation setting processes.

What are tips for success in structuring compensation in a merger?

Consider phasing in some of the compensation changes resulting from merger. For example, if one or both predecessor firms didn't previously use a bonus as part of the compensation system, the merger may involve a phased funding of the bonus pool over a multi-year period to allow for a more gradual impact on partner compensation.

Have an open mind about changes to compensation systems. Few firms are entirely satisfied with their compensation approach, so change through a merger can be an opportunity. Really look to best practices, not to protecting existing practices. At the same time, have a clear sense of what aspects of each firm's current compensation system contribute to the positive aspects of firm culture and should be preserved.

Be aware of how much partners will focus on partner compensation in the merger discussions. Partner compensation is typically the foremost issue in merger for many, if not most, partners, even ahead of factors like leadership, firm name, or the potential opportunities that might result from the merger. Leaders need to provide specificity around the compensation changes that would come with merger, particularly criteria, draw, and capital - to allow partners to gain comfort with the changes proposed.

Align compensation with the combined firm's strategy. Identify the primary strategic objectives of the merger and what the combined firm wants to value and ensure the approach to compensation supports those goals. If the combined firm's success will require teamwork, collaboration and cross servicing of clients, ensure those factors that are rewarded by the approach to compensation.

Recognize that compensation is a zero sum game. In order to pay one (or more) partners additional compensation at the time of merger, money will either need to be reallocated from other partners or result from profit improvement. Profit improvement can be difficult to achieve in the first year of a merger due to the time required to realize revenue and profit benefits from the merger, as well as integration costs, so compensation promises and guarantees require careful consideration.

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