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The Bonus Balancing Act

In our work advising firms on partner compensation structures, we are often asked about the best practice application of the bonus, particularly by those firms that don't currently use one. What are the criteria for bonus allocations? What percent of partners typically receive a bonus and what magnitude? How do firms avoid a situation where the bonus becomes just another source of competition for compensation and dis-satisfaction? How can the bonus be used to encourage team as opposed to individualistic behavior and performance?

The vast majority of large law firms, including most global firms, operate a merit-based partner compensation system. For many of the firms with this type of partner compensation approach, a merit-based bonus represents a key component of the overall system. Typically, the bonus, like partner base compensation, is determined subjectively and focuses on rewarding performance.

In an industry experiencing high levels of lateral movement and an intensified focus on the individual partner's portable book of business, firms need to take a robust and transparent approach to bonuses. To be effectively implemented, the bonus must be set based on clear, well understood criteria.

Among firms effectively applying a bonus structure, we tend to see three primary drivers for bonus decisions:

1. **Extraordinary Performance:** Bonus systems often serve as a tool to reward extraordinary performance among partners. This means that those individuals with one-off exceptional performance in a given year receive a bonus in lieu of being moved up in base compensation (e.g. a major bet the company case goes to trial and the responsible partner is unlikely to see another such matter for several years). By using the bonus to reward atypically high performance, firms avoid inflating base compensation for partners unlikely to repeat that performance year after year. And since bringing partners down in compensation is often avoided and never particularly pleasant, this allows firms to avoid unnecessary disappointment in future compensation decisions.

2. **Outliers:** In some firms, a small number of select partners generate a disproportionate amount of revenue relative to all other partners. Partners responsible for bringing in very high levels of revenue typically represent outliers within the firm's overall structure and compensation system. As a result of their high performance, these partners also tend to carry a higher degree of both risk and reward. While they are usually rewarded at the top of the compensation spectrum, the sheer size of their practice subjects the firm to greater financial risk and dependency on that particular partner. In these extreme scenarios, firms may use the bonus as a portion of outlier partner compensation. Akin to corporate models for highly compensated executives, this approach enables the firm to manage the risk associated with an outlier more effectively while ensuring that he or she is appropriately incentivized to continue to perform at a high level.

3. **Compensation Equalization:** A less common application is the use of the bonus as a means to address situations in firms with prospective systems in scenarios where compensation was initially set incorrectly by a fairly large margin. For example, a partner was slotted prospectively at the beginning of the year at a particular compensation level but by the end of the year demonstrated a clear and continuous course of performing at a much higher level. These situations are generally rare, as most firms know their partners well and are rarely significantly off in compensation setting. However, when such circumstances do arise, the bonus provides the flexibility to address an incorrect compensation decision. By using a retrospective bonus, a firm can ensure fair compensation for a partner whose compensation was inappropriately set on a prospective basis.

Given the limited occurrences of each of the above scenarios in most law firms, bonus allocations among partners tends to be fairly limited where extraordinary performance, outliers and compensation equalization serve as the sole or primary criteria for bonus allocations. In such applications, we see a small percentage of partners receiving a bonus each year (e.g. less than 10%). Through our compensation work, we have found that limiting the number of bonus distributions and, in parallel, making them of relatively significant scale tends to result in greater partner satisfaction. Furthermore, the criteria for receiving a bonus are distinct from base compensation allocations and transparent to the partnership. While some of the highest performing partners may be included in the bonus pool, it is due to a specific, atypical rationale – not simply good overall performance.

By contrast, firms that allocate bonuses to a larger number of partners (e.g. 25% of partners or more, but typically the top third performing partners in the firm) tend to find that the bonus is a more contentious compensation tool. In these cases, the criteria are frequently unclear and the allocations are often perceived as simply a method to give additional money to those already at the top. In some instances, this approach results in firms setting compensation twice – once for base compensation and once for bonus decisions - and the two decision processes lack distinction from one another. We also find that firms with a broad distribution of the bonus pool experience more partner tension over compensation. Scattering small bonuses across a large number of partners creates an environment where partners believe that they must compete for both base and bonus compensation amounts to get their 'fair' share. This results in additional emphasis on individualistic behaviors and a lack of orientation around team performance or contributions.

Under a best practice application with clarity in criteria distinct from that of base compensation, the bonus offers clear advantages. A bonus pool allows firms to reward extraordinary performance, avoid inflating base compensation for one off performance, reduce the compensation risk tied to outlier performance and even correct for errors in prospective compensation allocations. However, ineffective applications can also create unnecessary competition and interfere with a team culture. Successful implementation requires limiting distribution, clarity and adherence to bonus criteria, and a balancing of the need for rewarding star performance with the value of creating a collaborative, team oriented culture.

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