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Key Success Factors in Partner Compensation

Partner compensation season is upon us. At this time of year many law firms are in the thick of it, either just wrapping up compensation or entering the compensation setting period. It is also a time when firms reflect on the elements of their system which work well, and those which need to be improved. While many firms have fine-tuned their partner compensation systems over time, compensation remains an evergreen topic within partnerships, and one does not have to look hard to find ways to further improve a system. In evaluating a firm's partner compensation system, it is often helpful to consider the following key success factors as barometers for the effectiveness of the system and a way to highlight potential areas for improvement.

Success Factors

System construct: Merit or performance-based compensation systems (sometimes referred to as 'subjective' systems) remain the most common and successful systems for mid-size and large firms (e.g., firms with 100+ lawyers) operating with a range of practices and/or geographies and with the related range of partner contributions. Merit systems enable firms to recognize partners appropriately based on their level of financial contribution, including the revenue and profitability of work originated and fees collected on a partner's own time, as well as key contributions to building the firm in other capacities, such as management of key client relationships, practice group management, or building the firm's profile and reputation. Merit or performance-based systems are best described as 'management's assessment of individual partner performance and merit of contributions to the firm without a formulaic weighting of criteria.'

Clarity of process and criteria: Given that merit systems are the product of leadership judgment versus an objective formula, it is critically important that firms with merit systems communicate clearly about process and criteria. This is typically best done through a written summary of the firm's partner compensation system, which defines the firm's annual process for compensation setting and lays out the specific criteria and performance metrics which will be considered in the process. This is the opportunity for the firm to identify the broad range of partner contributions necessary to grow and build the firm, while emphasizing the most critical elements of partner performance. It should be noted that clarity of process and criteria is best achieved through clear communication and consistency over time. Firms which make frequent adjustments to criteria or process tend to experience greater partner frustration and a feeling that the system lacks transparency.

Gathering background data on contributions: Most firms spend hours poring over partner performance data in compensation setting. This is often appropriate, as the data certainly matters. For many merit-based firms, collections on business generation and working attorney time explain 80% or more of compensation outcomes. That being said, firms often invest too much time in looking at too much data or data which is not particularly instructive. For example, some firms look at too many years of data or they over-focus on metrics like billable hours or personal realization, instead of emphasizing revenue collected and client profitability. The reality is that there is no single metric which tells us the full story of partner contributions, so firms must consider a range of metrics. However, by focusing on a smaller number of high value metrics which are directly tied to firm performance and profitability, firms can increase efficiency in the compensation setting process and simultaneously achieve compensation allocations which align incentives with the firm's financial health.

Beyond quantitative data, best practice systems also seek to solicit qualitative information on partner contributions. This is often accomplished in the form of self-assessments, pre-compensation interviews and practice group leader input. In some instances, firms also seek out qualitative background on partner contributions from others within the firm, either in the form of partner peer review or a full 360 evaluation. (For further discussion, see our recent Insight on partner peer review).

Providing performance feedback: Partner performance feedback is a critical tool for any firm seeking to increase competitiveness, grow market share, or achieve financial goals. Some firms provide performance feedback to partners outside of the compensation setting process, but many others incorporate feedback into partner compensation sessions. Regardless of the timing, feedback is an essential tool for maximizing partner contributions to the firm and aligning partner efforts with firm strategy and direction. In addition to helping to address problems with underperforming partners or keeping communication lines open with top performers, feedback has also been shown to raise performance across the broad range of middle performing partners, often leading to material growth in revenue and profitability through more intentional and focused efforts of this group.

Managing relativity: It is not uncommon for partners to care more about what the partner in the office next door to them makes, than the actual dollar amount that they are paid. This preoccupation with relative compensation is one which plagues numerous firms, but it is far less prevalent in firms which avoid small differences in compensation, and instead, group partners with similar levels of total contribution together in compensation amount. This is often observed in firms with a formal levels system, or informally through ensuring meaningful differences in compensation groupings (i.e., at least a 7-10% at the low end, and typically 5-10% at the high end).

Linking compensation levels to performance ranges: More advanced applications of a levels system combine partner performance management approaches and compensation criteria through the use of a partner performance management framework. These frameworks define ranges of compensation (e.g., 3-4 levels per range) and the associated qualitative and quantitative contributions expected at each range. These frameworks provide an effective tool for communicating with partners about opportunities to increase total contribution and move up in the system.

Forward looking: Unlike retrospective systems which set compensation at the end of the year for the year past, prospective systems set compensation at the beginning of the year and typically establish performance goals and targeted metrics for individual partners which are aligned with compensation. The combination of a prospective system and a partner performance management framework offers the opportunity to incentivize partners with a carrot rather than a stick.

Adjustments: Effective systems also reflect a fair amount of fluidity in partner compensation. While necessary, annual compensation adjustments (meaning the movement of a partner up or down in a compensation system based on performance) can be challenging for firms seeking to balance short term profit maximization thinking with the need for long term investment in the organization. This balance is often accomplished by evaluating trends in performance over time and considering three years of performance data with an emphasis on the most recent year. With these principles in mind, we tend to see firms move roughly 15-30% of partners up, and another 15-30% of partners down in base compensation in a given year. These adjustments are necessary in order to align compensation with partner financial contributions and the market. In many instances, these are single level adjustments (e.g., 5-10%) in base compensation. This allows for firms to move in line with the market but avoid radical shifts in partner income. Although, in select outlier situations where partner contributions are more materially disconnected from current compensation, base adjustments may be as much as 25-30% in a given year.

Aligning the bonus: A merit-based bonus represents a key component of merit-based compensation systems and is particularly common in prospective systems. Typically, the bonus is determined at year-end based on management's assessment of partner contributions and focuses on rewarding extraordinary performance over the past year (although in some instances it is also used to recognize outliers or as a compensation equalization tool). Given the limited occurrences of these scenarios, firms with a more rigorous bonus approach limit allocations to a small percentage of partners (e.g., less than 10%). Through our compensation work, we have found that by limiting the number of bonus distributions, ensuring bonus amounts of significant scale, and distinguishing bonus consideration criteria from base compensation allocations, firms achieve greater partner satisfaction and understanding of the bonus as an incentive and performance management tool.

Getting both the partner compensation process and the allocations right is an annual challenge for law firms. By focusing on foundational elements of the system, firms can fine-tune their systems in ways which will improve clarity and more successfully align partner incentives and performance with firm strategy and direction.

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