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Factoring Profitability into Partner Compensation

Not all revenue dollars are created equal. Some clients and matters are more profitable than other clients and/or matters. Differences in profitability result from differences in billing rates, type of pricing arrangement, the level and amount of timekeeper staffing and hours charged (and importantly the respective costs of those resources), discounts, write-offs of unbilled and billed time, the level of specialty support required (e.g., docketing clerks, war rooms), or some combination of these factors. In spite of frequently material differences in profitability, many law firms continue to value revenue dollars equally. Firms that purposefully set aside profitability often argue, with some validity, that certain profitability analyses can lead to divisiveness and short-term thinking among partners. So, how should firms balance the important role of profitability with the challenges it can create in order to incentivize and encourage partners to pursue more profitable work or to manage the work more effectively?

Navigating the Challenges

A first hurdle in the discussion of how profitability should be considered in the context of partner compensation involves navigating the challenges with profitability metrics themselves.

Law firms have the ability to calculate profitability in a variety of ways, including client, matter, timekeeper, originating/billing attorney, office, practice group, industry team, and others. Many of the criticisms of profitability calculations arise out of the use of metrics which lead partners to modify their behavior in ways which do a disservice to the client or the firm, such as excessively discounting work, hoarding work, and refusing to staff matters appropriately. As a result, most firms have found that office, practice and timekeeper profitability (based on working attorney collections) statistics are useful tools for management analysis, but often problematic if distributed more broadly or used in a formulaic way for partner compensation setting purposes.

A more appropriate profitability metric in the context of partner compensation is client and matter profitability. Law firms are increasingly adopting client and matter profitability analyses as an input into the partner compensation setting process in order to help partners see the need to staff matters more efficiently, negotiate better billing rates or pricing arrangements, or improve their billing and collection practices. Client/matter profitability can also be rolled up by the originating or responsible partner to capture the profitability of a partner’s ‘book of business.’

To ease the adoption of client/matter profitability, many firms use nominal or budgeted values for certain inputs. The two areas where nominal values are most commonly applied include billable hours for associates (and in some instances, for partners) and partner compensation. While nominal value calculations may skew results on an absolute basis, a primary goal of law firm profitability analysis is to understand relative profitability and contributions, and the use of nominal values reduces the impact of outliers in hours and compensation and focuses the discussion on the relative financial value provided to the firm.

Tools for Success

Once firms have moved beyond general concerns about the adoption of profitability metrics and have the necessary metrics and reporting in place, the next question becomes, how should profitability be considered in partner compensation discussions and decisions?

Relative not Absolute Numbers: It is often said that law firm profitability (below the firm level) is an art, and not a science. This is meant to emphasize the important point previously discussed - given the nuances behind profitability calculations, profitability is best used as a tool for evaluating relative performance, not treated as an absolute number with a direct, positive or negative impact on compensation.

One of Multiple Factors: For firms with a merit-based or holistic compensation system, profitability should be viewed as one of multiple factors in evaluating a partner's contribution to the firm. Considering profitability in isolation results in a highly formula-based compensation approach and can lead to management, partnership and cultural challenges. In addition, profitability metrics do not lend themselves to a dollar value weighting, such as is often applied to originating attorney and working attorney revenue. Profitability metrics are standalone factors which should be evaluated on as one input into compensation allocations alongside revenue-based metrics, client development contributions, firm and practice management contributions, training and development contributions, etc.

Level Up/Level Down: Many firms with merit-based compensation systems seek to group partners together in compensation, either formally or informally, based on similar levels of total contribution. In evaluating profitability as one factor in compensation decision-making, firms should test for material, relative, under or over-performance in profitability. Partners identified as having metrics which are materially above or below other partners at their compensation level would be considered for moving up or down a level. By applying this approach, profitability plays a key role in influencing compensation outcomes without impacting compensation decisions based on an absolute analysis of the metric.

Performance Management and Coaching: Perhaps the greatest benefit of factoring profitability into the partner compensation setting process is the ability to meaningfully coach partners on how to improve the profitability of their clients and matters. Without a link to compensation, discussions with individual partners on client profitability often receive insufficient attention or action. However, when firms consider profitability in compensation and simultaneously work with partners to explain why certain clients are unprofitable and how the profitability of those clients can be improved, partners are typically more engaged in the conversation and more incentivized to make profitability improvements. This requires not only solid data reporting, but also coaching and tools needed for partners to understand how to modify the staffing, pricing arrangement, billing practices, etc. in a way which will yield a more profitable result for the firm.

Goal Setting: Increasingly firms are asking partners to set annual goals as part of the performance management discussions conducted at compensation time. This presents a high-value opportunity to encourage partners with lower profit clients to set goals around improving client profitability. In doing so, partners are given a specific objective which can be measured for progress/action and which can result in increased profitability for the firm and compensation for the partner involved.

Profitability is gaining traction in law firms and is increasingly being considered as a factor in partner compensation setting processes. When approached correctly, profitability metrics offer an opportunity for firms to not only compensate partners more appropriately based on profitability (rather than revenue alone), but also assist partners in improving the profitability of their clients and practices.

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