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Partner Compensation in a Year of Uncertainty

For many law firms, the month of June marks the halfway point in the firm's fiscal year, a time when leaders begin to more closely assess year-to-date lawyer performance trends, refine year-end financial projections, and evaluate the the need for mid-year partner performance messages. Of course, this June is unlike years past. This June, we face a tremendous amount of uncertainty in the broader economy and also within the legal industry. While many firms have already reduced expenses, year-end revenue and profit forecasts remain in flux. On average, timekeeper productivity has fallen 5-15% relative to this time period last year. Given the outsized impact that a drop in revenue can have on partner profits, many firms are expecting to see a decline in partner profits ranging between -5% to -25%. It remains unknown whether demand will weaken, strengthen or hold at current levels through the rest of the year, and whether collections will be either modestly or materially impacted by a broader economic slowdown.

Unfortunately, uncertainty does not leave us well positioned with regard to partner compensation. Experience has taught us that firms which manage partner expectations around profitability, year-end distributions, and potential compensation adjustments enjoy greater stability and partner cohesion. On the other hand, firms which surprise partners with bad news or draconian compensation changes tend to see greater dissension and more departures. In order to prepare for the 2020, partner compensation season (and possibly beyond), firms must begin now to evaluate how their compensation approach will differ from prior cycles. What types of allocation approaches will be used if the firm does not achieve budgeted profitability? What types of adjustments should firms with prospective systems make at the mid-year, if any, to address partners with materially declining practices? How should firms reward those partners whose practices are booming? How should leaders communicate about year-end profitability and potential compensation outcomes in order to manage expectations?

Range of Approaches

Since we anticipate that profitability will be reduced this year in many firms, now is the time for law firms to consider how they will allocate partner compensation based on a smaller net income pool. There are a range of approaches firms might adopt, depending on firm circumstances.

Proportional reductions: Proportional reductions entail an across the board reduction or percentage decrease applied evenly to the partnership, regardless of practice, office or compensation level. This approach espouses the theory of "equal pain" (and in good times, shared upside). In firms with unit or point systems, this is a natural consequence of a reduction in share value and works relatively well in most years where changes in net income are less dramatic. However, in a year where profitability may be significantly down, evenly applying compensation reductions may be more challenging, particularly for firms with disparate partner performance and a wider spread in compensation. A twenty percent across the board reduction in compensation will be felt differently by those at the top than those at the bottom, particularly in firms with a wide ratio of high to low compensation.

Progressive reductions: A progressive reduction approach involves a graduated impact on compensation with those at the highest end of the compensation spread taking a larger percentage reduction than those at the bottom. This approach results in a redistribution of income from higher performers to lower performers. This tends to work better in firms with a more paternalistic and "high glue" culture. However, firms with a larger number of laterals or less connectedness among partners may find this approach creates disproportionate angst among top performers and may trigger departures. And while it may work for one year, given the unusual circumstances, a second year could magnify partner angst and result in a loss of partner support.

Team-based reductions: A team-based approach focuses reductions on lower performing practices, offices, or sub-teams, while seeking to preserve compensation for teams experiencing high levels of demand and production. This approach may be useful for firms experiencing material performance differentials between practices, markets, or client segments, with select areas hard hit by a decline in demand, and others experiencing increased demand and heightened performance. The benefits of such an approach would be to preserve compensation for the firm's most competitive and highest performing teams during the crisis, however, it may also contribute to building silos and forming factions within the firm.

Individual contribution-based: An individual contribution approach is one which is consistent with existing merit-based compensation systems found in many law firms, with the primary distinction in 2020 being the relative weight of performance in the current year. Whether a firm is using a prospective or retrospective compensation model, typical merit systems involve evaluating partner performance and contribution trends to assess whether partners should move up, move down or remain at their current compensation level. The approach would differ somewhat this year as firms would more significantly weight performance over the past twelve months, give reduced attention to 3-year trends, and entirely set aside multi-year averaging.

The advantage of this approach is the direct link to financial contribution, and when implemented properly, it should result in paying for performance. However, this may be seen as contributing to more individualistic mindsets and less teamwork. For some firms, this approach will work best when coupled with a band or range for up/down movement of individual compensation allocations in order to avoid overly dramatic swings. In a more typical year, this band would range between 10-25%, however, given the greater disparity in performance across practices this year, we may see some firms move partners as much as 40% in compensation dollars paid.

Combination of approaches: For merit-based firms, the individual and/or team contribution-based approaches will likely be most aligned with the firm's historic compensation philosophy. As a result, some combination of these two approaches may be the most effective tool for addressing profitability pressures. The nuanced combination of approaches would involve ensuring sufficient rewards for high performing individuals while factoring in team performance and team contributions. By differentiating the impact of reduced profitability based on variations in performance and contribution, firms will stay true to the criteria inherent in their systems which will support improved stability and support for compensation allocations.

Mid-Year Adjustments

For firms with prospective compensation systems, mid-year adjustments represent a critical compensation tool this year. Now, more than ever, firm and practice group leaders should be monitoring partner performance and conducting regular communications with partners to discuss year-to-date performance, pipeline for work, and likely year-end results. In situations where partners are materially below their financial targets for the year (e.g. 30%+), the Compensation Committee and the relevant practice group leader will need to discuss what type of adjustments might be required in order to avoid material overallocations for the year. Once those decisions are made, leaders should conduct mid-year feedback sessions to discuss how the impacted partner might improve performance during the remainder of the year and the potential year-end compensation impact if performance continues to trend down through the end of the year.

Keys to Successful Implementation

In light of the profitability pressures many firms are experiencing this year, leaders will need to successfully adapt their partner compensation approach to respond to economic pressures and greater disparities in performance, while maintaining stability and adhering to the core principles and structure of the firm's compensation system. To accomplish this, leaders will need to focus on open communication, transparency, and clarity in the firm's compensation approach. Communications about the likely impact on compensation allocations need to start now so that the partnership can prepare mentally for how compensation will be different than they expected going into 2020. Communications should focus on anticipated modifications in terms of performance emphasis (e.g. multi-year trends/averaging vs. emphasis on the most recent year), and the potential range of movement some partners may expect to experience. By managing expectations and communicating clearly and early about an adapted approach, firms will be better positioned to preserve partner trust and a sense of transparency. Financial reporting and ongoing messaging throughout the rest of the year should reinforce partner understanding of how compensation and the allocation of profits will differ this year.

We are in the midst of a year unlike prior years and face challenges firms have not previously confronted, even during the

Great Recession. Now is the time for firms to assess where they are with regard to firm and partner performance and plan for the likely impact on compensation. The more preparation, communication and clarity the firm provides to partners about the potential differences in the firm's compensation approach and allocations this year, the greater the likelihood that year-end compensation allocations will garner support from the partnership.

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