fairfax INSIGHTS

Adapting Partner Compensation in High Profit Years

2021 appears to be shaping up much like 2020 – a banner year in terms of law firm financial performance and profitability. We anticipate that many firms will report growth in Profits per Equity Partner in excess of 10% for the year. If this occurs, 2020 and 2021 will be mark some of the highest levels of recurring profitability growth experienced for a large portion of AmLaw 200 law firms.

A second year of a premium level of profitability growth creates tremendous opportunities for law firms – but it also creates some significant challenges. As law firms have outperformed budget for two consecutive years, they have experienced a surge in profits available to pay partners. In a number of firms, partners with steady-state or even declining performance have experienced material compensation increases by virtue of the firm's growth in profitability – without an increase in their level of contribution to the firm. Historically, many firms have referred to this as a 'rising tide effect,' which has generally been seen as a positive aspect of partnership compensation but can also contribute to increased tension and management challenges.

The tension around this issue is in large part driven by the widening performance gap between low to mid-performing partners and those partners experiencing tremendous practice growth. Partners in high demand practices have dramatically increased their contributions to their respective firms – both in terms of client generation and personal productivity. While many firms are seeking to ensure these individuals are sufficiently rewarded for their contributions, it can often be difficult to move enough money to these partners given compensation system structures, bonus pools available, or even cultural resistance to widening compensation ratios. As high performing partners observe a second year of steady-state or low performing partners taking home dramatically more in compensation without an increase in contribution, frustration has risen.

Firms are now grappling with how to address these heightened tensions in order to maintain a sense of fairness in partner compensation, while preserving a sense of partnership. In doing so, a number of firms are rethinking whether their systems are set up appropriately to address profitability surges and to ensure compensation dollars are being appropriately allocated to those driving premium financial results. Key components of the partner compensation system under consideration include:

Ratio of High to Low

Years ago, some firms sought to tie compensation allocations to a pre-determined ratio of high to low. Over the past decade or more, law firms have largely abandoned this practice and increasingly stretched their ratios, even in years of more typical firm financial performance. In spite of this shift in the industry, some firms still continue to operate with an expectation that the system should maintain a certain level of compression in compensation. In years of extraordinary profit growth, maintaining historic ratios of high to low requires over-paying bottom performers or counseling them out. These approaches may be appropriate for certain partners but are unlikely to be appropriate across the board. A more strategic approach is for firms to recognize that the range of partner performance is widening and to reflect that growing gap in compensation allocations.

Prospective vs. Retrospective

In an environment where law firm profitability is surging well above budgeted performance, a retrospective compensation system (i.e., compensation setting at the end of the year for the year past) offers the advantage of determining allocations based on the firm's actual year-end profit pool. However, many firms would argue that the overall advantages of a prospective system (i.e., compensation setting at the beginning of the year for the coming year) still outweigh the disadvantages associated with anticipating unknown year-end results. Prospective systems typically establish performance goals and targeted metrics for individual partners, which are aligned with projected compensation. This approach offers the potential to incentivize a broader group of partners to enhance their contribution through goal setting and incentives (vs. relying solely on those who are intrinsically motivated by year-end compensation allocations). In addition, by applying realistic budgeting, clear

© Fairfax Associates

bonus criteria centered around extraordinary performance, and a reasonably sized bonus pool, prospective firms are able to effectively move money to top performers, even in years of unanticipated profit growth and overages.

Realistic Budgeting

Whether firms use a prospective or retrospective system, realistic budgeting (or a lack thereof) has implications on year-end profit distribution. Years ago, many firms sought to budget conservatively and/or below expected financial performance in order to provide a cushion that enabled management to exceed budget and surpass partner expectations for profit distributions. In the current environment, overly conservative budgeting runs the risk that an excessive profit overage is spread across the partnership based on the expectation that the rising tide should lift all boats. Through seeking more accurate and realistic annual budgets, firms are better able to manage compensation allocations and expectations. While years of extreme financial over-performance will be difficult to budget for or anticipate, starting with a realistic understanding of likely profitability growth puts the firm on better footing than an overly conservative methodology.

Bonus Pool Allocation Methodology and Size

A merit-based bonus represents a key component of merit-based compensation systems and is particularly critical to prospective systems in years of significant profit growth. 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. Firms with a more rigorous bonus approach limit allocations to a small percentage of partners actually achieving extraordinary performance, and in doing so, ensure bonuses are significant in scale and effectively reward those who have materially contributed to the firm's over-performance.

Another key element of the bonus system's application in high profit years is the size of the bonus pool. Bonus pools commonly range between 5-10% of net income, although there are certainly firms with larger and smaller pools. One of the advantages of a meaningful bonus pool is that it helps reduce the risk of over-distribution of a firm's excess profits to partners who have not materially increased contributions to the firm during the year. By ear-marking a sufficient profit pool for bonuses, firms are also able to ensure they have the funds needed to move money to top performers who had extraordinary years. However, this is not to say that the-bigger-the-bonus-pool, the-better. Often times, very large bonus pools can lead to a de-facto secondary form of compensation, requiring leaders review each and every partner twice for allocation purposes and leading to greater partner confusion and dissatisfaction around the system.

Also tied to the bonus pool, one emerging approach to address surges in firm profitability that has been experimented with over the past two years is a net income pool cap. Under this approach, a firm applies a realistic budgeting process at the start of the year, establishes a net income target, and defines scenarios around potential over-performance. The partnership then adopts a percentage cap, which redirects profit in excess of that pre-determined percentage over budgeted net income into an expanded bonus pool. This approach, when effectively understood and supported by a large majority of the partnership, allows firms to move additional funds into a bonus pool based on a significant performance over budget, without having to make permanent changes to the size of the bonus pool.

Getting partner compensation allocations right is a challenge for law firms even in a typical year. In years of banner profitability, particularly when that profitability has been driven by a subset of the partnership, these challenges are compounded. By thinking through foundational elements of compensation, firms can fine-tune their systems to ensure that the system is leading to allocations that fairly reward top performers, ensure a sense of fairness in partner compensation, and seek to preserve a sense of partnership.

WASHINGTON **CALIFORNIA** **LONDON**

Principals

Lisa Smith
lisa.smith@fairfaxassociates.com
202.365.4180

Kristin Stark
kristin.stark@fairfaxassociates.com
415.215.9294

© Fairfax Associates