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Partner Bonuses: Benefits and Pitfalls

The increase in lateral partner movement has put significant pressure on partner compensation across all segments of the legal industry. Lateral partners are often paid a premium to move and attracting high-performing laterals with significant books of business can require firms to stretch their compensation ladder. At the same time, firms are laser-focused on retaining their top performers. Younger high-performing partners are increasingly impatient with the historic “slow up/slow down” approach inherent in many partner compensation systems and expect to be paid in accordance with their current contributions.

Law firms across all levels of profitability are responding by adapting their approach to partner compensation from both offensive (growth) and defensive (retention) perspectives. A key tool firms have used is their bonus pool. More firms are adopting bonus pools, and those that have them are increasing both the size of the pool and the individual bonuses. While bonus pools historically averaged 5-8% of net income, they are now being stretched to 10-12% or more. Some firms’ bonus pools are as large as 25%.

A bonus element of compensation can be a powerful tool but may also lead to unintended consequences. Considering the benefits and pitfalls is essential for developing an effective bonus program

Benefits of Bonuses

Bonuses are particularly effective in firms with prospective compensation approaches where relative compensation is set at the beginning of the year. The bonus serves as a flexible component of compensation to reward partners who clearly outperformed expectations or whose performance consistently exceeds the top of the point scale. Typical use cases for bonuses include:

- **Rewarding episodic outsize performance.** Outsized performance due to a jump in business generation or a significant matter is increasingly being rewarded in the year it occurs, particularly if it is unlikely to be repeated. Bonuses allow firms to incentivize and reward strong performance without increasing base points or compensation, which might need to be rolled back when performance returns to normal levels.
- **Rewarding partners with variable high performance.** Bonuses can be used in lieu of adding point/share levels to reward consistently high performers without locking firms into high prospective compensation levels. Partners with significant originations may see greater variability in their books albeit at lofty levels, compared to partners with smaller books. But a c. $5m to $10m swing year over year, even if it is on a very large book, can be significant in terms of compensation metrics. A bonus element of compensation helps firms account for such variability, allowing top performers to be paid in line with their contributions. Firms are also finding they need to stretch their compensation scales to accommodate the highest performing partners, sometimes through "super points" or "bonus points," which are meant to be less sticky than base points.
- **Recognizing upward trajectories more quickly.** As noted, there is less patience for the slow up/slow down philosophy that underpinned many compensation systems. But many firms are better at moving partners up than down, so factoring sustained performance into point allocations remains important. A bonus pool allows firms to recognize the upward trajectory of high performing partners without locking into higher points before there is more evidence that it is sustainable.
- **Moderating point values as profitability accelerates.** In the past 3-4 years, many firms have experienced significant profitability increases. Larger bonus pools can moderate increases in point values or level values. While rising profitability intentionally benefits all partners in points-based systems to encourage a focus on firm performance, it can sometimes lead to overpayment of some partners relative to their contributions. Diverting money to a larger bonus pool helps to redistribute some of the uplift to the partners who drove the firm’s strong performance.

Bonus Pitfalls

While bonus pools can be a valuable tool to incentivize and reward strong partner performance, there can also be challenges. These include:

- **Overweighting individual performance.** The best compensation systems balance individual performance with firm performance. Prospective systems are designed to keep a focus on firm performance as the profitability of the firm will ultimately determine the value of a partner's share of the profits. Bonus pools can upset that balance if the bonus element becomes more important than firm performance and partners become more focused on maximizing their own compensation at the expense of the firm's performance. This is a greater risk with larger bonus pools.
- **Hoarding of work or credit.** Even in firms with a holistic approach to partner performance evaluation, bonus criteria are often based on a narrower set of specific metrics. This can result in more focus on those metrics, and some partners may be motivated to maximize those metrics in ways that are not optimal for the firm, including hoarding work that should be pushed down to others, or hoarding origination credit that should have been shared. Firms need to manage these behaviors and ensure bonuses are not formulaic.
- **Overuse of bonuses.** The larger a bonus pool, the more temptation there may be to allocate bonuses to more partners. Sprinkling small bonuses to many partners is harder to explain with clear bonus-worthy contributions and can become an expectation rather than a reward for performance. Bonuses should be meaningful (e.g., no less than c. 5% of compensation).
- **Lack of clarity.** While bonuses provide leaders with flexibility, unclear guidelines for bonuses can be counterproductive. While most partners understand the bonuses awarded to the top performers, partners may question bonuses given to partners for less obvious reasons. This can result in even partners who received bonuses feeling like they were under-rewarded, or resentment from those who did not receive a bonus. A robust feedback program can help overcome these issues.

We expect that partner compensation will continue to be a top of mind topic for law firm leaders in today's hyper-competitive market for top talent. Bonus pools are an important tool that provide much needed flexibility to recognize strong performance more quickly and retain top talent. However, as bonus pools grow in size and scope, leaders need to ensure that they are aligned with the firm's objectives and avoid potential pitfalls.

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