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Partner Compensation in Light of Changing Economic Models

For many law firms, partner compensation has historically been driven by a relatively consistent set of factors - origination (also referred to as book of business), personal collections, client responsibility, and contributions to the firm. While approaches vary from firm to firm, revenue generation generally plays a dominant role. A partner with a large book of business is typically viewed as making a significant economic contribution to the partnership. But what happens when similarly sized books of business produce dramatically different levels of profit?

Changes in pricing, staffing, technology, and service delivery are already creating increasingly different economic models within the same law firm. Of particular importance to partner compensation systems, these changes will produce greater dispersion in profitability across practices, partners, and books of business. As a result, firms will need to become much more effective at measuring profitability and incorporating those differences into partner compensation decision-making.

Different Work, Different Economics

Despite predictions about the demise of the billable hour, hourly pricing is likely to remain a significant component of the large law firm business model. Many types of work are difficult to scope in advance, highly variable in nature or driven by unpredictable events. For these matters, hourly billing continues to provide a relatively practical pricing mechanism.

In other areas, however, the economics of the practice are likely to change more substantially. Some practices involve work that is relatively predictable and repeatable. Portions of due diligence, contract review, regulatory analysis, discovery, documentation and other activities will increasingly be performed through a combination of AI, process improvement, and lower-cost timekeepers. As firms develop greater confidence in their ability to predict the cost of delivering this work, alternative pricing becomes more feasible.

Importantly, alternative pricing does not necessarily mean lower profitability. For example, consider a matter historically requiring $500,000 of attorney time for which a client agrees to pay a fixed fee of $450,000. If the firm simply performs the work in the traditional manner, the arrangement may be unattractive. But if technology, alternative staffing and better processes allow the firm to meaningfully reduce the cost of delivery, the fixed fee may generate a higher margin than the traditional hourly model. In this scenario, efficiency delivers economic value, and the partner who develops and manages this work should receive credit for the enhanced profitability of the matter.

The Efficiency Opportunity

AI makes the profitability topic more acute because it offers the potential to leverage knowledge management systems and, in some areas, staffing with lower cost timekeepers, to deliver a superior work product at a fraction of the historic cost. This creates very different incentives and opportunities depending on how the work is priced. Some partners and practices will manage this transition particularly well. They will identify work suitable for alternative pricing, understand its underlying cost structure, redesign staffing, incorporate technology and monitor performance closely to develop a service-delivery model that is both attractive to clients and highly profitable to the firm.

However, other partners and similarly situated practices may struggle to harness opportunities to increase efficiency and manage profitability. Alternative fee arrangements can be particularly unforgiving when work is poorly scoped or managed. A partner who agrees to a fixed fee but continues to staff and manage the matter in the same way as an hourly engagement simply transfers the economic risk from the client to the firm. Scope creep, excessive senior lawyer involvement, inefficient staffing and inadequate project management can quickly erode margins. As a result, two partners in the same law firm may generate identical revenue from alternative fee work while producing very different levels of profitability. A partner compensation system focused primarily on revenue will fail to recognize that distinction.

Premium Hourly Work

At the same time, the evolution of law firm economics will not favor alternative pricing in every practice. In highly specialized areas, clients increasingly seek lawyers with very specific expertise and depth of experience. Where the legal issue is particularly consequential and the supply of lawyers with relevant expertise is limited, price sensitivity declines significantly. For these practices, the appropriate strategy likely involves increasingly premium hourly rates. A highly specialized partner who successfully moves billing rates from $1,500 to $2,000 per hour without a meaningful reduction in demand can create substantial additional profit, particularly where the work is performed with an efficient staffing structure. The economic contribution of that partner's book may increase considerably even though the basic service-delivery model has changed very little.

By contrast, other hourly practices may face the opposite challenge. Associate compensation, technology, real estate and other expenses continue to rise, placing additional pressure on the cost of delivering legal services. Practices that fail to increase rates sufficiently to offset these rising costs may experience deteriorating profitability even as revenue increases. So, again, revenue-based numbers alone will not tell the full story.

Differentiating the Economics of Books of Business

Most firms already have access to significantly more financial data and analytical tools than they did in the past. However, in spite of the ability to measure profitability, many firms continue to shy away from profitability discussions to avoid internal tensions. Questions involving the allocation of overhead, the cost attributed to partner time, treatment of leverage and differences across offices or practices can lead to considerable debate. Overly complex profitability models also risk producing perceptions of black and white answers when the reality is in fact far more grey. Yet these challenges should not prevent firms from differentiating between economically strong and weak books of business. Going forward, it will become a strategic imperative for firms to distinguish between profitable and unprofitable revenue streams and incorporate that information into partner compensation decision-making.

It is important to note that profitability is not a black and white discussion, and therefore, a formulaic approach to factoring profitability into partner compensation decisions is likely to do more harm than good. Not all high-profit work is strategically valuable, and not all low-profit work is undesirable. A client relationship may initially generate modest profitability but create opportunities across numerous practices. A developing area may warrant investment before achieving target profitability. Other work may be important to the firm's reputation, market positioning or broader client relationships. Profitability should therefore represent one factor in a broader assessment rather than an inflexible formula.

Nonetheless, profitability needs to be a meaningful factor. Partners who build large, profitable practices through careful pricing, efficient staffing, effective use of AI and disciplined matter management should benefit from those efforts. Partners who command premium rates based on truly differentiated expertise should similarly receive recognition for the economic value they create. Conversely, partners who repeatedly accept poorly priced work, fail to manage fixed-fee engagements, overstaff matters or allow billing rates to fall materially behind rising costs should not be rewarded solely because their books produce substantial revenue.

Compensation systems influence behavior. If a firm rewards revenue without regard to the cost of producing it, partners will naturally focus on revenue. If a firm wants partners to take greater responsibility for pricing, staffing and service delivery, compensation needs to reinforce those priorities.

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Over the next 5 years, law firms will see a growing disparity in the profitability of books of business within the same firm. Now is the time for law firms to develop the tools and frameworks to see those differences clearly and factor such differences into the overall partner compensation decision-making framework.

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