Components of Compensation Systems in Successful Firms

by Joel A. Rose

There are numerous characteristics that account for good compensation systems in successful firms. These include:

1. Production. The commitment of time to client matters as well as the valuable commitment of non-chargeable time in areas such as business development and marketing, management, training, etc.
2. Personal receipts. The firm is already doing a very good job in this area.
3. Business generation. This includes attracting new clients as well as working with referral sources and former clients to attract additional business.
4. Business development and marketing. This includes being active outside the firm in pursuing opportunities to attract business and enhance the firm’s reputation.
5. Leverage. This includes delegating work to others and supervising that work. The opportunity is to continue to generate fees at a lower cost of production.
6. Profitable work. Partners should have an obligation to pay attention to the relative profitability of the types of work being handled.
7. Training and supervision of others in the handling of client matters.

Considerations for enhancing a firm’s compensation system:

There are a number of variables that should be considered to enhance a firm’s compensation system. Remember, “you get what you reward.” This will require the firm to move forward cautiously when considering many of these variables. There may be long-term and/or short-term consequences associated with incorporating any of these changes.

When considering the changes, it will be important to consider the entire package. The vast majority of the above variables, once incorporated into a compensation plan, will be interrelated. It will be important to understand the likely impact and potential ramifications of these changes when viewed as an integrated package. Some variables to consider include:

1. Rewarding partner contributions over a period of time rather than a single year. Some firms will consider a 3-year average; some may weight the most current year more heavily than the prior 2 years. The benefit for such an approach would be to smooth any wide swings in revenue production.

2. Prospective allocation of percentages rather than a retrospective calculation. The advantages of this approach include the ability to establish compensation
percentages at the beginning of the year so that profits become the focus rather than working to garner a greater share by individual and it oftentimes takes the focus off of one particular year and shifts the focus to trends in contribution over time.

3. Profitability is a key component in most compensation systems. Consider whether office profitability and client-matter profitability are important to the ongoing success of the firm. If so, it needs to be a component of compensation.

4. Hand-in-hand with profitability is the generation of additional business. Again, how critical is the generation of additional business to the ongoing success of the firm? Many compensation plans over-emphasize revenue from personal production, not generation of new business or maintenance of existing business. The latter are two key components in compensation plans in virtually every successful firm.

5. Effective management is a key element in the success of every business. Somehow, that has to be rewarded. Yet, most firms struggle with how to reward partners for their role in management. Resist the urge to base the reward on the amount of time spent by each partner. Similarly, resist the urge to attach a stipend to each management position. Reward effective management; it is key to the future success of every business.

6. Many firms adopt a compensation plan that rewards partners for their contributions over time. Some of those systems have incorporated an annual bonus pool component that is used to reward extraordinary performance during a particular year. We generally recommend a three year “look-back”

**Strategies for Improving a Compensation Systems:**

The key in designing any compensation system is to develop and understanding of the firm’s vision and direction. A well-designed compensation plan becomes one of many tools a firm can use to help reach its strategic goals. Remember, you get what you pay for. Lawyer management cannot move the firm in a different direction unless the compensation system goes in that direction too. So, a compensation system must have as its foundation, the basic premise of what the firm is hoping to achieve. The factors that the compensation system emphasis will become the emphasis of the firm, i.e, business production, new business, hours, management, delegation, transition of clients, etc.

Generally, changes to any compensation system should be viewed more as evolutionary, than revolutionary. The focus of every new compensation plan should be on business production, business origination, business retention, management,
delegation and profitability. These are the major determining factors for ownership in many successful law firms.

The Compensation systems in many of the more financially and professionally successful law firms include a number of major components:

1. Base salary. This usually serves as the backbone of a firm’s compensation system. Many firms have a defined salary structure. For example, consider adopting a fixed, 5-level salary system. (75% of the first $150,000 and 50% of all amounts above)

<table>
<thead>
<tr>
<th>Avg. Comp (prior 3 years)</th>
<th>Salary</th>
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<tbody>
<tr>
<td>under $150,000 ($150,000)</td>
<td>$150,000 @ 75% = $112,500</td>
</tr>
<tr>
<td>$150-199,999 ($175,000)</td>
<td>$150,000 @ 75%, $25,000</td>
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<tr>
<td>@ 50%</td>
<td>= $12,500 $125,000</td>
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<tr>
<td>$200-249,999 ($225,000)</td>
<td>$150,500 @ 75%, $75,000</td>
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<tr>
<td>@ 50%</td>
<td>= $37,500 $140,000</td>
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<tr>
<td>$250-299,999 ($275,000)</td>
<td>$150,000 @ 75%, $125,000</td>
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<tr>
<td>$125,000 @ 50%</td>
<td>= $67,500 $180,000</td>
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<tr>
<td>$300-349,999 ($325,000)</td>
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<tr>
<td>$175,000 @ 50%</td>
<td>= $87,500 $200,000</td>
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<tr>
<td>over $350,000 ($350,000)</td>
<td>$150,000 @ 75%, $200,000</td>
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<tr>
<td>$200,000 @ 50%</td>
<td>= $100,000 $222,500</td>
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</tbody>
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2. Quarterly draw. It is the practice of many firms to distribute monies to partners quarterly, or as cash flow permits. Also, it is the practice of many firms to match their quarterly tax payment. We suggest tying the amount of quarterly tax distributions to base salary, since that forms the basis for the tax requirement. In large part, this is also a cash flow issue.

Tax draws should be relatively small. The expectation should be that there is sufficient cash flow generated by the firm’s operations to meet the quarterly tax draw schedule. The firm should not be placed in a position where short-term bank borrowing will be required to meet salaries and quarterly tax draws. It is recommended that your firm should err on the side of conservatism when committing firm funds to be distributed to the partners.

Other factors which should be considered when setting compensation include:

- Client Origination. Contribution to origination and development of new clients, individually or shared.
- **Client Retention.** Additional business from existing clients, oftentimes the product of quality work satisfactorily performed by members other than the partner who originated a client account.

- **Quality of Work Product/Timeliness.**

- **Partner Productivity.** Productivity is an aggregation generated by the hours the partner works, by the efficiency with which the work is handled, the number of matters handled, the effort generated through working with other lawyers in the firm, etc. It also includes the value of time worked, and/or delegated to others, the condition of the partner's accounts receivable and work-in-process inventory, the extent to which he/she properly utilizes other attorneys and other firm resources, etc.

- **Seniority.** Seniority is not age alone, nor is it only the number of years a lawyer has been with a firm, however. Rather, it means the number of years the partner has spent developing and maintaining clients, building and enhancing the firm's reputation and participating in the training and development of a cadre of lawyers who produce for the benefit of all the partner in the firm.

- **Firm Management and Practice Team Leadership.** Contribution to firm management, including efficiency and effectiveness in handling management assignments, is critical to the firm's future and must be recognized.

- **Compliance with Firm Policies.** This includes: Abiding by policies to keep time accurately, to turn in time sheets promptly, to follow policy on billing, collections, etc.; Turning over client management and other controls to other lawyers when appropriate; Contributing to the equitable and efficient distribution of work assignments and client contacts; Specializing and developing expertise in particular areas to complement other abilities in the firm, etc.

- **Personal Relationships and Teamwork.** Practicing a team concept, including participation in, and cooperation on, firm committees, etc. is expected, client sharing, client introductions, and overall promotion of harmony and goodwill among firm members is critical and absolutely expected.

- **Partner Participation in Firm Activities/Functions.** Partners are obligated to attend firm social and professional meetings, participation in those management decisions and activities which appropriately fall upon partners and participating fully in the "drudgery" side of the business.

- **Lawyer Development and Delegation of Work.** Time and effort in working with younger lawyers to increase their professional skills. This includes the training and development of associates and paralegals.
• Professional and Community Activities. Contributions that enhance the firm's image and prestige through maintaining good relations with other lawyers, speaking at CLE programs, publishing, participating in bar activities, and assuming bar and community leadership positions, etc.

• Overhead cost allocation. Determining the allocation of overhead is often a tricky proposition for many law firms. We suggest that the calculation be kept simple. Consider following these steps to determine a fair allocation of overhead: Determine the number of full-time equivalent lawyers and paralegals. This is a standard industry calculation. A full-time equivalent is determined based upon the number of months a “timekeeper” (attorney and paralegal) is employed by the firm. A timekeeper employed for 4 months counts as one-third full-time equivalent; a timekeeper employed for 6 months counts as one-half. Allocate salary, including quarterly bonus, plus a 20% benefits factor to every timekeeper. Take the remaining expenses and allocate those amounts to every timekeeper on the basis of their timekeeper classification and full-year equivalent. For allocation of general overhead, we will assume a factor of 1.00 for every associate, 1.50 for every partner, and .40 for every paralegal. Based upon our experience, this approach will result in a fair allocation of overhead to every timekeeper.

The results of applying these recommendations to your firm’s compensation system should be a fair compensation to the partners, when viewed over time. In any one year, there could be some anomalies, however a longer-term view is more appropriate.

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Joel A. Rose is a management consultant who specializes in law firm management and legal economics. He can be reached via telephone at (856) 427-0050 or (800) 381-1645 or via email at JROSE63827@aol.com. This reference material is provided as a service by the author. PBA makes no guarantees regarding the accuracy, completeness or currency of the information.

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