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Formulas Work in the Lab, but They Don't Work in Many Firms Compensation Systems

Ranking alongside, or perhaps ahead of, Jason's search for the Golden Fleece and King Arthur's quest for the Holy Grail, is law firms' search for the idea compensation system. Jason eventually found the Golden Fleece and some firms feel they have found the equivalent in their compensation system, but King Arthur died without every finding that precious cup. In this changing legal profession today, many firms continue their search for the compensation equivalent of the Holy Grail.

In the long history of the legal profession, this odyssey has had more twists and turns than a John Grisham novel but basically they have boiled down to four systems: Parity, Lock Step, Formula and Subjective or Non-Formulaic.

Parity & Lock-Step

A parity system is usually found where two or more lawyers agree to practice together and split the profits based on previously agreed upon percentages. It is really a formulaic system based on profits. After a few years, or as the firm grows, the system is usually changed. Except in some start-up situations, parity systems are rare today.

A lock-step system often evolves from a parity arrangement. In this system partners are assumed to age like fine wine and are compensated based on seniority. Their incomes increase at a pre-set level until retirement. In a sense, lock-step is also a formulaic approach. This system is increasingly rare today

But even on Olympus, some gods outrank others. What has made parity and lock-step systems rare was the introduction of a radically different approach: Compensate partners based on performance. It was at this point that the two most widely used systems today – formulaic and subjective – first appeared. It was also when the real twists and turns in the compensation plot began.

Formulas

The basic principle of performance-based compensation is simple. The practice of law, like every other profession, is also a business. Therefore, the lawyers must be productive. There are just two problems: 1) What are the criteria? 2) How can they be measured? As Shakespeare put it, "Aye, there's the rub."

Probably because both parity and lock-step systems are essentially formulaic, many firms initially developed their performance-based systems around formulas. They gathered objective data and then applied a mathematical formula to measure performance and determine compensation. From this point different formulas developed as firms searched for their own Holy Grail.

Some formulas are quite simple, based on either billable hours or collections. Others are more complex because they include additional factors such as origination, write-downs and write-offs. Still others are *extremely* complex and include such factors as allocation of overhead. Formula-driven firms usually describe their system as "Eat what you kill."

The main appeal of a formulaic system, simple or complex, is that it is “objective” and “fair”. It also minimizes or even eliminates the management time in making compensation decisions.

Subjective or Non-Formulaic Systems

Even in the earliest days of performance-based systems, some firms used a subjective approach. In many of these firms, however, the process is opaque and shrouded in mystery because there are no published or generally accepted criteria which are at least nominally considered. Furthermore, a growing number of firms with subjective systems collect and consider *objective* data. This includes realization (after *both* write-downs and write-offs), origination and marketing activities and also *qualitative* factors such as firm and practice group management, training and development of associates and client service and feedback.

Whether the compensation systems is formulaic or subjective, to be generally accepted by the partners and regarded as fair, it must be transparent. The factors that will be considered must be published and their application to each partner must be disclosed to the partner. Furthermore, for those partners who consider their compensation unfair, they should first have the opportunity to submit a self-evaluation and then the additional opportunity to meet with the compensation group. Some firms have an “open” system in which each partner’s compensation is published to the entire partnership. Some of these firms also have the partners vote on the proposed comp.

The Trend

Despite their benefits, firms that have had formulaic systems have been increasingly discarding them for subjective systems or, if they have kept their formulas, have added a subjective component to them, often in the form of bonuses.

There are many reasons for this trend. To begin with, formula systems are not truly objective. Any partner who wants to “game” the system can do so. They also encourage work hoarding and a “sole practitioner” attitude that discourages client service and cross-marketing. But the most important reason is that, to survive and compete today, firms need their partners to take, not a short-term, “me-first” view but a long-term, “firm-first” view and perform certain functions that cannot be calculated in a formula.

For most firms today, while the quest for the Holy Grail of compensation continues, the search has been narrowed to some form of subjective or non-formulaic system. In other words, formulas still work in the lab but no longer in many law firms.

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