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

This is the time of year some firms begin the process of addressing partner compensation so this seems like an appropriate time to review the subject again.

In the long history of the legal profession, many firms' search for the ideal compensation system has had more twists and turns than a John Grisham novel but basically they have boiled down to four systems: Parity, Lock Step, Formulaic or Performance-Based 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. After a few years, or as the firm grows, the system is usually changed. Except in 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 rather than on some measure of performance. Their incomes increase at a pre-set level until retirement. In a sense, lock-step is really a formulaic approach. Fortunately 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: Compensation based on some measure of 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.

### **Formulaic or Performance-Based**

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 so that the firm will be profitable. There are just two problems: 1) What are the criteria for productivity? and 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 have developed performance-based systems around formulas. They gather quantitative data and apply a mathematical formula to measure each partner's performance and then determine his or her compensation. Some formulas are quite simple, based on either billable hours or collections. Others are more complex because they include additional factors such as origination and realization (after both write-downs and write-offs) and even allocation of overhead.

The principal appeal of any formulaic system, simple or complex, is that it is "objective" and "fair". Note that also it minimizes management time in making compensation decisions.

## Subjective or Non-Formulaic Systems

Furthermore, even though some firms describe their system as performance-based, it is really subjective or non-formulaic. In many of these firms the process is shrouded in secrecy because the factors which are supposedly considered are not identified. Fortunately, a growing number of firms with subjective systems begin the process by collecting and considering *quantitative* data but also include *qualitative* factors such as marketing, business development, 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 accepted by the partners and regarded as fair, it must be transparent. The factors that will be considered must be published. Some firms invite partners to submit a self-evaluation and discuss this with each partner when advising them of their compensation. In firms that do not have initial self-evaluation, partners who consider their compensation unfair, still have the opportunity to meet with the compensation group. Note that both of this systems requires the investment of management time.

## The Trend

Despite its benefits, firms that have had a pure formulaic system have been increasing discarding it for a subjective system as described above. 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. Formulaic systems are not truly objective. Any partner who wants to “game” the system can do so. Formulas 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 large and many mid-size 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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