Altman Weil, Inc.

Report to Legal Management

September 2009
Volume 36, Number 12

OUR 35TH YEAR

EDITOR

James Wilber
Principal
Altman Weil

CONTRIBUTING EDITORS

Ward Bower
Principal
Altman Weil

William F. Brennan
Principal
Altman Weil

Thomas S. Clay
Principal
Altman Weil

Timothy B. Corcoran
Senior Consultant
Altman Weil

James D. Cotterman
Principal
Altman Weil

Daniel J. DiLucchio, Jr.
Principal
Altman Weil

Charles A. Maddock
Principal
Altman Weil

Alan R. Olson
Principal
Altman Weil

Eric Seeger
Senior Consultant
Altman Weil

Pamela H. Woldow
Principal
Altman Weil

MANAGING EDITOR
Susan D. Sjostrom

Compensating Partners and Associates in Trying Economic Times

James D. Cotterman

By James D. Cotterman

To say that we are in trying economic times may be a bit of an understatement if you are un/under-employed or employed at a reduced level of compensation. Law firms have struggled to find equilibrium between the work available and the staffing required to do it, as well as between the price clients will pay for that work and the cost to the firm to service it.

Firms have been making serial adjustments to their personnel ranks. Layoffs, furloughs, reduced hours, wage freezes and reductions have all been part of the arsenal. There is a tremendous amount of humanity in the profession — you can sense it in the concern that leadership has over the layoffs, wage freezes/reductions and how they affect their people. But at the same time, there is also less patience with underperforming lawyers. Firm cultures are under great stress. The cultural belief that "we are all in this together" works within limits. This recession has stretched, and in many cases exceeded, those limits. Much of this has to do with the economic model of private law practice in the US.

The cost structure of a law firm is 78% labor, 8% facility and technology, and 14% other. The facility and technology costs are most often long-term leases and contracts that will not be easily broken. The "other" category has potential savings but there are some practical realities. Within this category are your basic operating costs, a good portion of which are not going away. You can conserve on some, maybe defer some, and eliminate a few.

That leaves labor and its associated costs. There are a variety of options for law firms, depending on the depth and likely duration of the shortfall of work as well as the firm's need for immediate expense relief. Drastic work/staffing imbalances will direct a firm to certain options, whereas an imbalance at a manageable level will open up different remedial measures. Law firms are labor-intensive businesses. That is where the money goes and that is where the savings are. With their limited access to capital, the length of time any firm has to correct an imbalance is extremely short. So what are law firms doing with respect to compensation as these events rain down on them?

continued on page 5

Inside This Issue

Compensating ... *continued from cover*

Partner Compensation

First, they put into perspective the risks they face. If key business generators perceive their compensation to be inadequate and their firm to be at risk, they may take their clients and leave. Highly talented, technically skilled lawyers may be open to recruiter inquiries to move to a more financially stable (i.e., income-secure) law firm. There are enough firms in good financial shape with adequate capital to take this opportunity to shop strategically for talent. Sadly, the drain on talent usually starts at the top and works its way down. If permitted to continue for even a short while, the lawyers left in the firm may not constitute a sustainable enterprise.

Second, there is a stricter enforcement of economic contribution expectations. This recession has eviscerated whole practice groups. Where the firm might absorb the loss of a few clients, it might be hard pressed to do so for many. Accordingly, the window to right or retool a practice has become much shorter — months, maybe a quarter or two, but not a year. Consequently, firms are considering more individualized compensation adjustments if a first round of across-the-board reductions is insufficient.

Third, there is greater weight given to recent performance. It is common for partner compensation systems to consider past performance (average and trends) equally with current year performance in setting compensation. That balance is now shifting in favor of current-year performance.

Fourth, there is a heightened concern about what message may be perceived in the compensation adjustments and decisions. There is keen pressure to make the very best compensation decisions, to reinforce leadership messages by rewarding specific qualitative behaviors, and to provide pay proportional to performance without abandoning firm values. The challenge to getting this right in the midst of so much turmoil is daunting.

> ***"Current economic circumstances require... a more internally consistent and externally competitive set of decisions."***

Therefore, law firms should try to reframe the process. What is the firm paying for? What messages do their decisions send? Are they consistent decisions? Do they reflect what the market would pay? Current economic circumstances require a sharper focus, a more disciplined approach, and a more internally consistent and externally competitive set of decisions.

To do this analysis and achieve these ends, law firms will need to look at correlation studies and market risk assessments, among other things. After reaching some conclusions, the next step is to determine how the compensation decisions can be improved.

Associate Compensation

There is a great deal of talk about reforming associate compensation — most of it centered around two approaches. The first is an absolute roll back of starting compensation that will ultimately affect every class year. The second is, once again, to reform or eliminate the lockstep associate compensation programs that are entrenched in law firms.

The first, salary rollbacks, is a reality check arising as a result of pressure from clients. Clients are increasingly hesitant, if not downright unwilling, to accept first and second year associates on their matters. Their billing rates (necessitated by supersized compensation packages and equally supersized overhead — the combination of which can equal $500,000 in large firms for the first-year associates) far exceed the value these newly-minted lawyers can offer. We are seeing reductions from 10% to 20% in base salary across the board.

Now that enough market-leading firms have reduced associate compensation, it will be much easier for the balance of the profession to do likewise. The effect of this will be interesting to watch. It will lower costs and ease cash flow immediately. It will also reduce the gap between market leaders and the pay levels of the rest, as well as between the large and small firms. And since the associate pay reductions appear to be predominantly among market leaders and large law firms, it could allow a very few firms to hold the line and finally achieve by recession what they could not accomplish with relentless pay hikes — a separation in starting pay that is not immediately matched by the market.

The second area, lockstep associate compensation, has been talked about for years. A few firms have taken on the issue with reforms of varying degrees, including abandoning the concept altogether. However, one does not know if the announced changes yielded substantive change in how associates are being compensated. Remember there are two reasons why lockstep has lasted so long. First, it is easy for the firm to administer, particularly when it knows that a sizable percentage of its young lawyers will transfer out within a few years. For the single tier firms, this turnover of associates is required

continued on page 7

Compensating ... *continued from page 5*

since only a few will survive the tournament to the top.

Second, for all of its purported shortcomings, the lockstep system has resulted in remarkably merit-based compensation decisions. There is a means to determine how important merit is in associate compensation decisions. The test is a statistic known as R-squared. It tells us how much of the variation in compensation can be explained by a particular variable. In this case, the variable we can examine is performance measured by value of the associates recorded time. Through our research, we have large databases of associate time and productivity. The strength of the relationship (R-squared) between the value of associates' time and compensation is remarkable at .92 where 1.0 is the maximum value. Essentially only 8% of the variability in associate compensation is explained by all factors other then productivity. Can you get more merit driven than this? Not if you want any ability to consider other aspects of the associates' contributions. In professional services where the model is selling the value of your experience and expertise, the foundation of any compensation program has to measure time value.

Summary

For now, law firms are in triage mode. Good partner compensation decisions that limit the risk of losing key people and recognize short-term performance are paramount. Associate compensation is being reduced to reflect current economics. Longer term, firms may make larger changes to systems and processes. As the recession fades and we gain a better sense for which old market forces will survive and in what manner, we will see more thoughtful programmatic reviews of compensation programs. ◆

James D. Cotterman *is a principal of Altman Weil, Inc., working out of the firm's offices in Florida. He can be reached at (407) 381-2426 or jdcotterman@altmanweil.com.*