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Compensation Risk Assessment


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Law firms are facing a severely depressed economy, tight credit markets, skittish partners reluctant or unable to contribute capital, and price sensitive clients. They have responded with serial adjustments to their personnel ranks. Layoffs, furloughs, reduced hours, wage freezes and reductions have all been part of the arsenal. Non-personnel expense reductions continue to be sought, but the fiscal reality in professional services is that labor represents 78% of total costs and the essentially fixed cost of facilities is another 6%. There is only so much one can do to save money outside of personnel reductions. Now, firms must wrestle with pay decisions for those remaining.

When dollars are plentiful, it is easy to be generous to all and still satisfy the high producers; but when dollars are tight, internal equity and external competitiveness become increasingly difficult to achieve, especially when the high producers send subtle (and often not so subtle) messages about the inadequacy of their compensation. This is the true test of a firm's values and culture. Unfortunately, in challenging times, we all too often find that the bedrock of the firm's existence is compensation, while culture and values fall to the side. This is what we see too often in law firms in this current environment.

The compensation *status quo*, however, may be a dangerous option to pursue. If key business generators perceive their compensation to be inadequate, they may take their clients and leave; and highly talented, technically skilled lawyers may be picked out of the firm. The effect is a loss to the organization, a reduction in its ability to generate fees and profits, and a disruption in the lives and livelihoods of all stakeholders. Many firms intuitively understand the risks, but few have the ability to assess that risk in a systematic way.

Understanding Compensation Decisions

When Altman Weil advises law firms on compensation, we focus on the *quality of the compensation decisions*. The various types of systems and processes are simply tools to achieve good decisions. We examine a firm's program to determine if the compensation decisions demonstrate the

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following characteristics:

- they allocate remuneration proportionately to contribution (merit);
- they are competitive with comparable market decisions (external equity);
- they are determined consistently from person to person and year-to-year (internal equity);
- they reflect the firm's culture and operating philosophy;
- they demonstrate that what leaders say is important is really what is rewarded (credibility and trust); and,
- they recognize and reward those activities that implement the firm's strategy.

We test to see how well the firm's compensation decisions achieve these goals.

Correlation Studies

One set of tests are *correlation studies*. The purpose of a correlation study is to gain an understanding of what factors the compensation decision makers took into account in making their determinations. Each dot on the scatter graph below represents an individual partner.

A scatter graph visually assists in identifying what, if any, patterns exist between two variables. The more scatter or randomness that exists in the "picture," the lower the correlation between the variables. The *trend line* is another visual tool to help identify a pattern in the data. The more highly correlated the data, the tighter the fit between trend line and dots. Positively correlated data move in unison and in the same direction. Negatively correlated data move in unison, but in opposite directions.

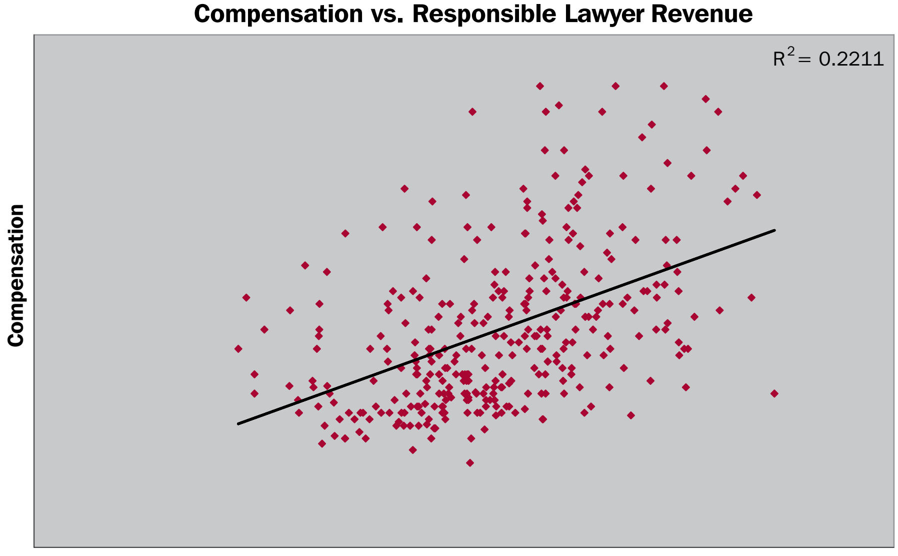
In the upper right corner of the graph is the R^2 value. This statistic quantifies the strength of the relationship between the variables. A value of zero means that there is no observable relationship between the variables. A value of 1 means the variables are highly correlated.

The example below looks at the correlation between compensation and responsible lawyer revenue. You can see that there is some pattern in the array of dots; some relationship between responsible lawyer revenue and compensation. But there is a fair amount of randomness as well. The R^2 value of .2211 is somewhat consistent with the strength of relationship we find in the legal profession between personal productivity and compensation. This scatter gram tells us that we can explain about 22% of the variability in pay by the variability in responsible lawyer revenue at this firm. It also tells us that 78% of the variability in pay is explained by some other factors. Additional variables are studied until a more complete picture emerges of what the compensation decision-makers did and did not take into account to make their decisions.

Multiple variables should be examined to aid an understanding of how much influence one variable has over another or the extent to which the decision-makers used a particular variable in a systemic way. It does not explain the process or rationale used to reach the decisions, or the decision for any individual partner — but it may point to areas of systemic inconsistency and highlight questions to pursue further.

Individual R^2 values (those values which are a shorthand for the strength of the relationship between compensation and various decision factors) cannot be added together to determine the combined effect that two variables have on another. There can be significant overlap between variables. For example, good business generators are almost always strong personal producers. Business generation tends to be highly correlated with partner compensation. Let's use .84 for example. The correlation of personal productivity to compensation is generally around .23. But the strength of the relationship of both personal production (.23) and business generation (.84) is not 1.07. In reality, it will more likely be .85 or .86 because the two variables overlap each other. To discern the relationship of two or more variables to compensation we use another statistical tool called *multiple regression*. Multiple regression removes the overlap to understand the combined influence of two or more variables without double counting.

Compensation vs. Responsible Lawyer Revenue



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Identifying these patterns helps us understand what is behind the decisions in order to determine if they are consistent with the firm's stated desires for its partner pay program. Is the decision process consistently and fairly applied? Does compensation reflect overall merit (a basic tenet of any well functioning pay program)? A systematic data analysis will reveal the answers.

Partner Productivity Analysis

A second set of tests are *analyses of partner productivity* (personal and business generation). Following are distribution tables that depict the proportion of partners performing at varying levels of personal productivity and business generation. This illustrates the nature and spread of economic performance and aids in our assessment of the firm's vulnerability to weak market conditions.

Such an examination might appear as follows:

An array of personal productivity: Table 1 depicts the number and percentage of partners whose personal productivity falls within various bands of expected performance. This table focuses on the most recent year's performance for working lawyer fee receipts as its metric.

Table 1. Personal Productivity

Under $400,000	49	36%
$400,000 to under $500,000	44	32%
$500,000 to under $600,000	20	15%
$600,000 to under $700,000	18	13%
$700,000 and over	6	4%
Sum of analysis	137	100%
Check total	137	100%

An array of business generation: Table 2 depicts the number and percentage of partners whose business generation falls within various bands of expected performance. This table focuses on fees received on the most recent year's performance with a lawyer's book of business as its metric.

Table 2. Business Generation

Under $300,000	47	35%
$300,000 to under $500,000	28	21%
$500,000 to under $750,000	28	21%
$750,000 to under $2,500,000	32	24%
$2,500,000 and over	1	1%
Sum of analysis	136	100%
Check total	136	100%

An array of the combination (personal productivity and business generation): Table 3 compares data underlying the prior tables to determine in stark terms the percentage of partners who generate work in excess of their personal production ("exporters"), those who "break even," and those who require support ("importers"). We can also see the distribution at varying levels of export and import. It shows data not only for the most recent year but also a multi-year average and a multi-year weighted average.

The firm's partners in this example have improved their ability to cover their personal production with more partners generating work in excess of what they themselves do ("exporters"). This is evident from the most recent year's data indicating 55% (i.e., 44% + 11%) are net exporters compared to the multi-year average of 52%. However, 38% (9% + 29%) of the partners still are not self-sufficient, a decided weakness in this economy.

Identifying individual exporters, those who only break even, and those who import work from their partners is critical to making rational compensation decisions. The next section outlines how to use this data.

Market Ranges

A third set of tests, *market range*, analyzes whether compensation decisions are within or outside a predicted range for each lawyer's economic performance. They also help us to understand the compensation decision in the context of the individual's ability to generate business. This is a very powerful tool, as it not only identifies the risks in incorrectly rewarding different levels of business generation, but it also places that in the external context of the compensation decisions relative to market. An example of that analysis is below.

Partners in a sample law firm have been categorized as Entrepreneurial Leader, Business Generating Partner, Self-Sufficient Partner, Service Partner, Below Service Partner, and Technical Specialist Partner. These terms were set forth and defined in the author's article, *Making the Grade: What Should Law Firm Ownership Really Mean?* (available at www.altmanweil.com). They are used to categorize a partner's ability to create revenue-producing business opportunities for the firm.

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Table 3. Personal Productivity and Business Generation

	Most Recent	Average	Weighted Average	Average of the three metrics
Significant exporters	44%	41%	42%	42%
Small exporters	11%	11%	9%	10%
Break even	7%	8%	8%	8%
Small importers	9%	12%	12%	11%
Significant importers	29%	28%	28%	29%
Sum of analysis	100%	100%	100%	100%

+/- $100,000 threshold between small and significant
+/- $20,000 threshold for breakeven

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In Table 4, the first row shows the actual number of partners in each category, while the second row shows the same values as percentages. The third and fourth rows indicate those partners who are compensated below the market range (row 3) and above the range (row 4). Numbers in red highlight general areas of concern.

Forty-six, or 34%, of this firm's partners have not demonstrated a sustained ability to generate revenue-producing business opportunities at a level sufficient to meet expectations of a service partner (they are those partners who were classified in the "Below Service Partner" column).

a heightened risk of losing important contributors in a firm where that skill set is not well dispersed among the ownership group.

There are also 26 individuals who are paid above their predicted range (row 4). Only two of them are significant business generators and 21 are not self-sufficient. Both of these scenarios are red flags for this law firm, indicating significant risk.

A word of caution. This tool highlights risk factors. It does not indicate that any particular decision was bad. It does allow the consultant and the firm to engage in a frank discussion of each specific

Table 4.

Comp. > Range	Comp. < Range	Entrepreneurial Leader	Business Generating Partner	Self-Sufficient Partner	Service Partner	Below Service Partner	Technical Specialist Partner
26	60	2	38	22	29	46	0
19%	44%	1%	28%	16%	21%	34%	0%
	60	1	18	14	10	17	0
26		0	2	3	3	18	0

Compounding this problem for the sample firm is an additional 21% of the partnership who are rated as "Service Partners." When combined, these two categories represent a full 55% of the partnership who are not self-sufficient revenue generators. These individuals require the support of others to keep busy. Having more then half of your owners in this situation is a sufficient challenge in good markets. To face this in a deteriorated market is a bit of a nightmare.

We can also see that 19 of the firm's 60 partners who are paid below their expected range (row 3) fall into the categories of Entrepreneurial Leader and Business Generating Partner, i.e., those partners who can drive business into the firm in a meaningful way. This represents

case to determine its individual appropriateness and what, if any, action should be taken.

Armed with information like this, we can have an informed discussion about how a law firm's compensation committee is carrying out its charge. We can consider an array of changes that will improve decisions, as well as other changes to inoculate the firm against disruptive departures. Such changes are often quite complex to implement. As one partner so eloquently stated it, "You can't get turkeys to vote for Thanksgiving." Change will result in some people getting less, while others take more. The compensation changes could also coincide with changes in partner status or even separation. Instituting safeguards such as a compensation floor, collars to the amount of change in the first year or two, and transition assistance can protect individual lawyers from undue economic hardship. These are some of the hardest decisions leadership must make; but they are also some of the most important if a firm is to survive turbulent times. ◆

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