Compensation Risks in a Down Economy

A Discussion Between Jim Cotterman and Tom Clay

On April 8, 2009, Altman Weil principals James D. Cotterman and Thomas S. Clay sat down to discuss how the current economy is affecting compensation decisions in law firms. They talked about associate compensation reductions, law firms lessening tolerance for underperformance in their partner ranks, and the heightened risks of making bad compensation decisions in a down economy. This discussion is a companion piece to the article by Jim Cotterman, "Compensation Risk Assessment," which appears on page one of this issue.

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James D. Cotterman

Thomas S. Clay

Clay: Jim, you and I have been working with law firm clients on some serious and knotty problems over the last four to six months having to do with issues of compensation, layoffs and reductions in force, overhead reduction in law firms and things of that nature. I don't think that we're at the end of all that quite yet. There's still work to be done. Are you finding something similar?

Cotterman: Yes, unfortunately. Our law firm clients' clients are still contracting. And as long as they're contracting, they are going to put pressure back through to their professional advisors, their vendors, their suppliers and so forth, and I don't see an end, certainly not this year, maybe not until the first or second quarter of next year.

Clay: Well I certainly get the question often of "When will it end?" and "How far do we need to go on cuts?" I think, at least right now, most firms have done as much as they possibly can in cutting non-essential things out of their general overhead. Now they've started in on people. The first cuts among associates have been those associates that frankly didn't have any work because of the client business contractions you mentioned.

Cotterman: Yes, and I think some firms may be taking an opportunity to address hiring mistakes that were ignored when they were busy. Then they said "Well, this person may make it, or maybe they won't, be we're not going to do anything about it." Now I think firms are much quicker to do something about it.

Clay: Yes, that's certainly something we've been preaching for a long time — the importance of dealing with those issues. But the money has papered-over dealing with the mistakes. There seems to be a growing thought that associate lockstep compensation may well go by the wayside, especially with respect to larger firms where associates are being asked to take across-the-board pay cuts in return for not losing their jobs.

Cotterman: Well, there's always a lot of talk about moving away from associate lockstep. But the data that we look at certainly don't seem to demonstrate that firms have done much on that. Associate pay tracks associate revenues. That's good when the revenues are going up. It's a disaster when the revenues are collapsing as they are now. So this is the lockstep where you're going down the stairs rather than up the stairs. Firms are saying to associates, "You're generating 15% or 20%

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less revenue than you did last year, so your compensation is going to track with it." That means it's going to come down 15% to 20%.

Clay: Well, if we begin to ratchet back based upon real economic performance, then the question is: is this just a blip, or will it go back to the status quo? I think that there's not much reason to think it will just go back in terms of pay. Most people would say associates are being paid far above their value in the real marketplace.

Cotterman: I think the other issue is clients. Lawyers have been able to get these tremendous increases in compensation primarily because they've been able to raise their prices enough to cover it. If the clients start to say no to rate increases and start to really press for more value, which in their minds is going to mean more and better services for less outlay of cash, this will severely constrain profits. Then I think you're going to see a collapse in the pay structures for partners and associates as a consequence.

Clay: Well let's talk about profit declines. You said that partners may not make as much this year as they did last year. Over the years, there seems to have been the expectation of making more money every year — as a birthright almost — and that's not the way most businesses operate. I don't think it would necessarily be a profession-wide disaster if partners didn't make more every year. Law practice will still be a terrific profession. What do you think?

Cotterman: It would certainly be a very extraordinary awakening for those individuals. Good or bad is in the eye of the beholder. Law firms have been able to raise prices at twice the rate of inflation for two to three decades now. Compared to most marketplaces, that's an extraordinary reign of control over the market. I'm just wondering if it may have come to an end. And if it has, then I think you are right, I don't think partners and associates are going to be able to count on wage growth as they have historically.

Clay: I think it will cause them to think about other ways to be profitable. I've thought that the way many law firms, particularly big ones, made more and more money, along with increased rates, was through brute force. More work meant more people, not more efficiency.

Cotterman: They did it with leverage.

Clay: Right. And if firms achieve new efficiencies and they are dedicated to those efficiencies and alternative fees and things of that nature, I don't think they necessarily have to make less money as a partner.

Cotterman: No, but it's going to mean a change. There has to be a delta someplace — either in pricing, profits or process. Those factors all can't remain static.

Clay: I agree and I think the delta's going to be in the basic business model by which firms deliver service. If they get more efficient, price appropriately and focus on value, I think partners — and I will admit that this probably means there are fewer associates and fewer people making partner — but I think partners can do just fine if they get it and they implement some of these changes.

Cotterman: There are going to be some old habits that will be hard to break, so when the market turns there will be a tendency to slide back into those comfortable shoes. But I think maybe we're at the point where the marketplace has finally said, "That way is just not going to work anymore."

Clay: Well we've certainly seen evidence in the press and in our own practice that general counsel are saying they don't expect we'll ever go back to the way it was.

Cotterman: They may stick to it this time.

Clay: I think there's a real potential for that. How about partner compensation? If in fact the economy remains level or down or does not come back as fast, what's next? Most of the layoffs we've seen have been with associate lawyers and support staff. Now we're beginning to see some signs of potentially a second round that will look at equity partners. What do you think might happen with the whole compensation philosophy and structure in these firms if, in fact, they start to look closely at partners?

Cotterman: There are a couple of things that I'm seeing. One is that there is still a tremendous amount of humanity in these firms. You can sense it in the concern that they have over the layoffs, the freezes and reductions and how that affects their people. But I also see a greater sense that firms can't be as tolerant of underperforming aspects of their businesses, whether that be an office, or a practice, or an individual. There's a higher level of impatience in these firms, driven by angst over the fact that there's just not enough dollars to go around and no matter what they do, they're still hemorrhaging. They're not building those distribution pools like they used to. There's concern that the compensation system is going to put the firm at risk. If they were to carry the same compensation decision pattern forward that

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they've been using over the last three to five years, it would mean that very high producers are going to leave significant amounts of money on the table — far more than they have historically — because the other elements of the firm are struggling so mightily to try to generate revenue.

Clay: I'm seeing the same thing and hearing a little bit of trepidation from firms that may have to start looking at equity partners a little harder and, as you suggest, with a little less tolerance. But at the end of the day I think you have to do what's right for the organization as a whole, and if that means less tolerance for unproductive resources, then isn't that okay?

Cotterman: Yes, but it's a harder question when you're talking about partners — because they are the organization. You have to separate the ownership aspect from the contribution aspect. If you were an outside investor in this business, you would want to ensure that the business entity was a viable economic entity, and you would address these issues differently than if you were inside the tent yourself. And that's the hard part. It's so very difficult for partners to wrap themselves around that particular problem.

Clay: Sometimes there is a sense that, "Once I become an owner I've arrived and it's the end of other obligations." If in fact a firm can't raise the bar or get partners to deliver on heightened expectations, then forces will overtake the firm and will put the organization at great risk.

Cotterman: Part of the problem is that when you get in the room and you're at the table where the compensation decisions are being made, you also realize that this is no longer an academic exercise. What I find is that there are inconsistencies in the ways that the programs are administered and applied to individual partners. There are inconsistencies that are systemic — firms may think that they are giving a certain amount of weight to a particular skill, contribution or attribute, and yet, when you do the analysis you find out, lo and behold, they aren't. At least not in any systematic way.

Clay: When you have a lot of human beings sitting around talking about evaluation of people, and doing it in a subjective way, you're going to get those inconsistencies.

Cotterman: Yes and there's something to be said for subjectivity, because it's difficult to quantify everything well. The systems you need to have in place in order to do that are pretty rigorous. But the starting point is to understand what you're doing with your decisions, exactly how you're weighting the decision, and what you are and aren't taking into account in some sort of systematic way. You can see whether or not that's consistent with what you wanted to do in the first place. So part of your problem may be you just don't make the decisions in the way that you wanted to make them. You're letting yourself get sidetracked for some reason and you need to get back on track.

Clay: You run the risk of underpaying a star or overpaying an underachiever — and both can cause major problems.

Cotterman: Yes, the other key step for the firm is to systematically analyze and isolate where the risks lie. Where are the weaknesses within the ownership group? Where are there pay decisions that seem inconsistent with a proportional pay for proportional effort and results? Is the firm failing to balance appropriately long-term contributions in the organization and the very short-term? Say you look at a partner who has been a contributor for 30 years, but who hasn't done anything in the last two, and you decide to keep moving his or her pay up. That may or may not be the right answer. The same thing is true if somebody has one great year and you're going to double their pay. They've done nothing up to this point. They've hit the ball out of the park and now you're going to double their pay. Again that may or may not be the right answer. But you've got to have some context in which to frame these questions or you can get very distorted results that can be quite harmful and quite difficult to undo later on.

Clay: So you can institutionalize some mistakes that are really hard to correct later.

Cotterman: Yes.

Clay: We're always trying to search for pay equity and equality in these things, and it's hard to do when you have subjectivity involved, but isn't it also hard to do if you just look at the numbers? I mean, the numbers don't just tell the tale.

Cotterman: I think that's correct, but the inescapable foundation in building a professional service firm is that for the most part you have to have engaged, profitable timekeepers. If all you're selling is professional services, at least based upon the model that's in place today in the vast majority of firms, you must have productive, profitable timekeepers or it just does not work. Now in large firms, yes, you can have a managing partner who doesn't practice law or who practice chairs and spends half their time practicing law. But that cost is spread over a large organization that can afford to absorb the cost as part of making sure they're run-

ning the organization appropriately. But for the most part you have to have productive timekeepers who are operating at a profitable level. Even if you go to an alternative system like contingent fees, it still comes down to the fact that the people there have to be productive; they have to be putting fees on the books. If that's not happening, then you don't have a viable enterprise. So the numbers are an underpinning that cannot be ignored and if you don't get that piece, it doesn't matter what you do with the subjective element.

Clay: If there are not dollars there, then it doesn't really matter?

Cotterman: It really doesn't matter. And if you look at the marketplace, it is telling us consistently year in and year out that somewhere around 15% of pay is the amount of compensation that moves around based upon factors other than pure hard economics.

Clay: This year that 15% is going to be a much smaller amount in a lot of law firms.

Cotterman: It certainly is. Our whole practice is built around the quality of the decisions that come out of a compensation committee. This year, there are fewer dollars to go around, there is less patience within the firm amongst the partners, there is real fear about how bad it's going to get. You can't afford to be making okay decisions. Your decisions have to be top-notch.

Clay: I think the litmus test for most firms is 1) are you keeping your stars, and 2) what's the level of griping among other partners? By that standard, most firms think they're doing a good job and making good decisions. But if I understand you, they may not be accurately assessing the potential risk because they don't even see it looming out there.

Cotterman: That's correct. And the risk is that you could find out that you've made a mistake when your most valuable partner comes in and sits down and says "I've decided I'm out of here in 30 days." You can assess the quality of the decision based upon the feedback you're getting from the partners, the level of grumbling, and how well you're holding on to your key people, but you're doing it at the wrong end of the timeline.

Clay: I don't think that partners leave just because of money. We know many, many lawyers could leave and they choose not to, so there's something else that's keeping them. I think part of the decision issue is whether or not the firm is reluctant to deal with the non-producers. If that's the case, it certainly drives the producers a little bit crazy and in this economy maybe even crazier.

Cotterman: They may not leave because they were offered more money, but the money may be the culminating event and that gets right into your point. If you don't demonstrate with compensation that you, as a leader of the firm, are managing the firm's progress through this economic storm, partners are going to get nervous about a lot of things. And it may not be that another firm is offering them more money, it may mean that they are offering them a better platform, a more stable platform, a less risky platform. Partners have to have comfort that their careers are in a firm that is going to be able to sustain itself.

Clay: What I'm hearing you say is ambiguity may well be the biggest risk out there. Uncertainty may well lead someone to think about making a move.

Cotterman: It will entice you to take a call you may not have taken in the past, to have a drink or dinner with someone when you may not have in the past, to have a conversation that you probably would have brushed off and said "No, not interested." So a firm that isn't well managed, and that includes an unfair compensation system, opens up the door for somebody to start selling to your partners, when in the past they never would have been able to begin the sale.

Clay: So no one can really remove all risk from any of these equations, but if I hear you, we need to take a look at the compensation philosophy, methodology and results and at least be willing to ferret out risks that we might not even know are there at this minute.

Cotterman: That's right. There's no silver bullet that indemnifies you against all risk. This is a matter of looking at what you are doing within your firm and asking, "Are we taking the prudent steps to address the risks that we can do something about?" It's just one more thing that you have to put on the plate and unfortunately the plate's getting kind of crowded these days. It's just the way it is. We're living in unprecedented times. ◆

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