

Report to Legal Management

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Examining Your Compensation System



James D. Cotterman

By James D. Cotterman

Altman Weil, Inc. recently released its fourth survey of compensation systems in private law firms. This examination, which began a decade ago with the first such study, provides a look into the methods and philosophies of compensating law firm owners, associates, paralegals and staff.

Responses to the questionnaire varied most by size of firm. However, certain structural differences in forms of law firm organization also accounted for differing replies to some questions. These differences lie primarily in the tax treatment the organizations and their owners receive.

This article provides an overview of the key findings in the survey, augmented by the author's experience in advising law firms on compensation systems.

Compensation Systems: 2003 Survey Findings

In Altman Weil's first survey on this subject in 1993, law firms were almost evenly divided on prospective, retrospective, and combined approaches to when the compensation decision is made. A decade later, a retrospective philosophy prevailed in 41% of the systems, while 32% adopted a mixed (prospective and retrospective) philosophy. The clear loser over the decade has been the purely prospective approach. This reflects a market-driven need to recognize individual performance more

quickly in order to attract and retain quality people. It is too early to conclude if this trend will make firms more competitive long-term or possibly more fragile in a market dominated by shifting loyalties.

The two most important compensation criteria in law firms remain a lawyer's ability to bring new clients to the firm and personal productivity measured by fees collected as a working lawyer. Personal productivity edged out business origination overall. However, if firm size is considered, the view changes considerably.

When asked about the proportion of owner compensation distributed on a subjective basis, survey participants provided a striking response. One quarter indicated that no portion of owner compensation is subjective. Three out of ten respondents indicated that 76% to 100% of owner

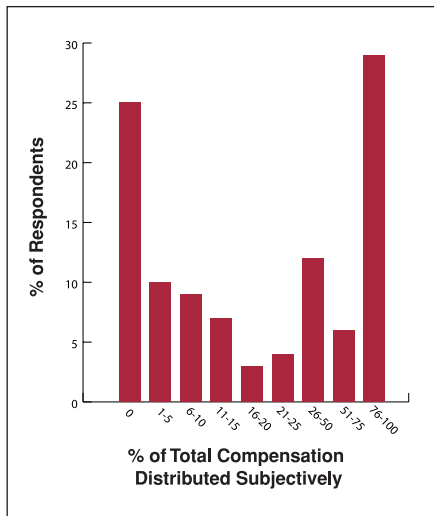
continued on page 3

Inside This Issue

Editor's Message: New Survey Reveals Top Determinants in Partner Compensation	2
Subjective Law Firm Compensation Systems, Marketing and Origination	6
How Clients Choose	8
New Survey on Law Department Administrator Compensation Released	9
Mining Surveys: Cost of Branch Offices	10
News From Altman Weil	11

Examining... *continued from cover*

compensation is subjective. The responses of the remaining 45% of survey participants were scattered between 1% and 75% of compensation distributed on a subjective basis.



Compensation committees are used less by small law firm participants. Large law firms continue to rely heavily on such committees. Most often, these large firm compensation committees are separate committees that may overlap the firm's management organization. The next most common configuration for a compensation committee is the management group plus additional members serving solely for compensation decisions. The partners select these additional members most often.

The partner compensation process is a participatory event. Personal interviews are the most common means partners have to provide input. Written materials are the second most common communication vehicle partners have with the compensation committee. The most common post-decision communications are appeals to the committee and follow-up interviews. The author supports the efforts of a very large minority of firms (24%) to conduct post decision interviews because it is so easy for the committee's "message" (compensation decision) to be perceived by the

recipient differently than it was intended. This is true irrespective of a good, neutral or poor determination by the committee.

Overall, about 30% of participants had a second class of ownership, although firm size played a significant role with 16% of smaller firms and two-thirds of large firms having a second class of ownership. Individuals in such a class shared profits more often than they shared in voting rights or capital obligation.

Associate signing bonuses are provided by about one-fourth of the participants, the same as reported in 1997 and 2000. More lateral hires are receiving these bonuses than in the past, while recent graduates are less likely to receive a signing bonus.

In the 2003 Survey, 22% of firms have some sort of lock-step feature for associates, down from the 25% in 2000 and 30% in 1997. Expect this trend to continue.

Over 80% of the law firms surveyed consider paralegal assistants and exempt staff eligible for performance bonuses in 2003. 76% of firms consider non-exempt staff eligible for performance bonuses, down from over 80% in the 2000 study.

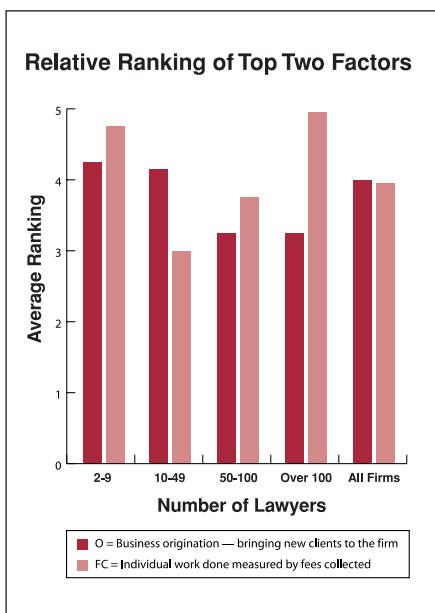
Outside payroll services are used by almost 73% of the participants, up from 63% in 1997. While 54% offered direct deposit of paychecks in 1997, over 70% do so today.

Compensation Systems: Business Origination

Although business origination is consistently ranked as the #1 or #2 compensable factor, less than half of the law firms surveyed grant "formal" origination credits. Again firm size significantly influenced the response. 72% of firms with more than 100 lawyers provide formal credit for new business, while only one-third of small law firms formally allocate new business credits. It is obviously easier to have a good intuitive understanding of how new business

is generated in smaller firms than it is in larger firms. When law firms undertake a formal allocation of origination, there is likely to be some heightened emotion involved. Remember, that in allocating the credits you are measuring not only one metric of productivity, but also an individual's ability to truly master his or her own destiny. Those are powerful forces.

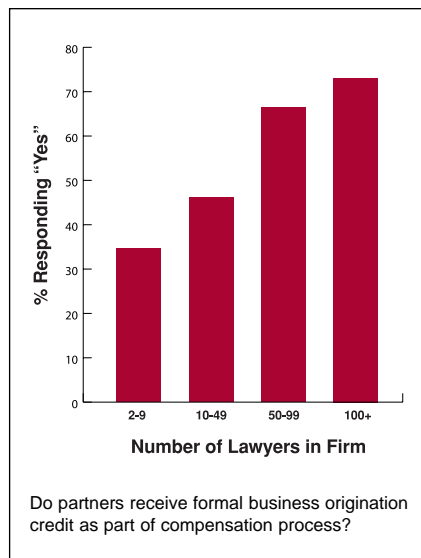
The author has participated in the design of formal origination systems and the subsequent efforts at making the initial allocations. Some of these projects go very well, while others are far more difficult. An underlying element in the former that is lacking in the latter is the ability to control combustion statements.¹ Combustion statements are those phrases or comments that clearly indicate frustration, irritation, and obfuscation. If a process exists to establish a common framework to measure business origination and prioritize the protocols, it is possible to prevent the combustion statements from turning into explosion points. Explosion points tear at the fabric of a law firm; they are de-motivating at best and destructive over time at worst.



continued on page 4

Examining... *continued from page 3*

The process the author has used successfully in these situations (arising originally from client work and subsequently expanded) is one in which certain vignettes or scenarios are prepared and presented to the partners. The partners are asked to allocate origination credits based on differing facts set up in various vignettes. By analyzing and scoring the different fact scenarios, the partners develop a set of parameters that can be the basis for further discussion (perhaps at a firm retreat). This creates an opportunity to define the firm's own vocabulary and protocols, and to prioritize those protocols. By following these steps,



the partners will have a behavioral model to guide them day-to-day in making origination credit allocations.

Although a significant proportion of large firms do not resort to formal credits, those firms can still benefit from the process described above. They will likely have a broader goal — that of defining the general types of partner in terms of *business origination capability*. The author has developed a model that includes five types ranging from the 'entrepreneurial leader' to the 'technical specialist partner,' with each type defined by

likely size of the book of business as well as other significant traits. Firms might use such a model, or establish their own, to categorize partners into broad groups. A general classification is often easier and less controversial to implement. A side benefit of this system is that it is an entrée into aligning compensation criteria with admission to ownership criteria and performance evaluation criteria.

Compensation Systems: Acceptance

Law is a very competitive profession. When coupled with a fluctuating economy, significant likelihood of legislative reforms and wary clients, lawyers struggle with the challenge of dividing a pie that is not sufficient to satisfy everyone. When dollars are plentiful, it is easy to be generous and to satisfy the partners, but when dollars are tight, internal equity and external competitiveness become increasingly difficult to achieve.

Compensation is one of the more complex, serious and emotional issues that confront law firms. Many other issues that arise are the result, at least in part, of dissatisfaction with compensation.

Compensation represents a tangible expression of a person's value. It defines lifestyle, position within a community, status among peers, friends and family, and measures the relative importance of the individual to the organization. There are no easy compensation answers and complete satisfaction is rarely possible. Instead, partners should strive to reach certain objectives. The basic purpose of a compensation system is to attract and keep the right people in your firm.

If there is a universal rule with respect to compensation, it is this: Every compensation system works — and every compensation system fails. Systems run the spectrum from objective to subjective, from participative to dictatorial. What works in any particular law firm is a system

that fits the culture and strategy of the firm. That means that a good compensation system should be flexible in order to survive differing needs of the firm as well as its changing ownership. A system must be embraced by the partners and be consistent with their collective philosophy, background and perspective.

All successful compensation systems feature two common qualities. Each is inextricably linked to the other, hopefully, forming a bond that stands the test of time. First and foremost, a successful system must be perceived as fair by the partners. Fairness should not be confused with satisfaction. Fairness is measured by a sense of equity in treatment with respect to others, which is a separate issue from satisfaction with one's own compensation.

The following questions define the perception of fairness:

- Do I understand the compensation system?
- Does the system recognize the different contributions that individuals bring to the organization?
- Are the rules of the compensation system simple, clear and well understood?
- Are the rules applied in a consistent manner from year to year?
- Are those individuals making the compensation decisions and applying the rules of the compensation system trusted and respected colleagues?

A second quality of a successful compensation system is that of simplicity. Altman Weil's experience has shown that there is a direct correlation between the simplicity of a compensation system and the degree to which the members of the firm understand how their compensation is determined. That, in turn, goes a long way towards the perception of fairness. Simplicity is the foundation. Each additional consideration or metric in

a compensation system should be measured against the standard of simplicity. The addition of complicating factors to a compensation system or formula should be weighed against the following standard:

Am I truly gaining an insight into an individual's contribution that is worth the additional complexity?

The difficulty in making compensation system recommendations for a law firm is in selecting the best mix of compensable criteria, the best combination of subjective and objective determinants and the right amount of participation that is consistent with the firm's needs and its culture.

A law firm is fluid through time. It changes and the compensation system needs to function like a good constitution — grounded in good, basic principles and subject to amendment only after careful, thoughtful deliberation. The experience of an expert, the objectivity of an outsider, the candor of confidential input all work together to facilitate a firm's progress in changing or developing a compensation system.

When reconsidering a firm's compensation system, the expression of and exchange of information regarding an individual's compensation expectations is an important event. Fundamental facts come into play.

- What does compensation mean, both personally and professionally, to each individual?
- How much money is enough?
- What level of risk sharing is each individual willing to assume?
- How much disparity from top to bottom is reasonable and tolerable?
- Among all factors of professional accomplishment, how important is dollar compensation to each individual?

The following generalities should assist you in positioning your firm's experiences and evaluating the need

to reform your compensation system. If your firm is not consistent with the generalities and the system is working, then do nothing. If your compensation system is not working, however, then look for differences and see if the general guidelines offered below provide some direction.

Compensation Systems: Evaluation Criteria

Law firms have moved to bifurcate compensation from ownership. That is, relative compensation levels do not track relative levels of ownership. This should always be true for those lawyers practicing in a professional corporation. Partnerships over the past decade have begun to follow. In so doing, the meaning of ownership has changed. Ownership is now looked upon as a means to apportion the owner capital needs of the organization and to establish certain voting rights in the governance of the firm's affairs. The level of importance accorded ownership in compensation has decreased.

Likewise, pro bono and other non-billable activities outside of the law firm have suffered in importance, meaning and relevance. Such endeavors did not translate into fee receipts within the short-term orientation many partners have with respect to profitability. Lost in this is the experience lawyers gain in leadership skills, exposure provided to the communities' business, political and civic leaders and the benefit the community receives from involvement.

Some law firms have sought to preserve or regain collegiality and stability. Therefore, tenure with the firm, contributions to training and mentoring younger personnel, adherence to and support for firm policies and the respectful treatment of staff are accorded some importance in those firms.

Smaller firms can still sit down and discuss an equitable distribution of the pie. Larger firms often find such meetings awkward and inefficient. As firm size increases, so does the use of compensation committees.

Such committees are typically composed of members who place the interests of the firm above their own personal interests.

Law firms have moved to measure fee collections via objective criteria such as working lawyer productivity, billing lawyer productivity, origination and portfolio responsibility. Billings or hours may often fall short for partners because a partner's responsibility does not end until the bill is actually paid. However, billings and hours are good secondary and tertiary factors to put anomalies into proper context.

Lawyers who manage their firm's business functions, serve on committees, and manage the legal function sacrifice a portion of their practice in order to improve the operation of the organization. Those managers should be paid, and today the trend is to recognize those efforts. Managers treat the firm as a client and should be given credit for their efforts as if the firm was, in fact, a paying client. Firm approved budgets, combined with documented authority and performance expectations, provide a framework for such considerations.

Practice-specific differences exist. Most intellectual property firms, for example, gravitate toward a formulaic and objective compensation system. The lawyers' scientific disciplines and facility with numbers are the primary reasons. Insurance defense firms have unique institutional relationships with clients that require different compensation criteria than would a transactional practice. Plaintiff's litigation firms, while transactional, tend to be boutiques and to exhibit a highly entrepreneurial tendency which needs to be addressed in any compensation system.

Firms are increasingly looking to align their value system with that of their clients. This means that the law firm wants to reward its people for behaviors which serve its clients' interests best. Clients, as well, consider

continued on page 12

Examining... continued from page 5

the influence of a pay program on behavior and have begun dialogues with their outside counsel.

Further, many law firms are putting more emphasis on performance pay as a component of total compensation. Salary increases will likely be more modest as firms attempt to fund performance-based bonus programs. Bonus awards look to measure substantial contributions made by an individual which materially enhance performance of the team, unit, department, office and/or firm.

Conclusion

Firms involved in consideration of changes to their compensation systems recognize the dangers of simply maintaining the *status quo*. Key business developers may take their clients and leave; highly talented, technically-skilled lawyers may be bought at auction; management may suffer, and the like. The effect is a loss to the organization and a disruption in the lives and livelihoods of the members.

It is equally true that firms recognize the danger in change. In any closed economic system, a change in compensation system is likely to result in some people getting less,

while others take more. This danger can block compensation reform within a firm. Prospective change and transition become key elements in the evolution of a compensation system. Change needs to be prospective, i.e., forward looking, and it is important to provide time for the players to adjust to a new rulebook. Many firms also take specific action to prevent massive reductions in compensation due to implementation of a new system. Limits on downward adjustments are enacted to protect individual personal economic circumstances. This step is a major consideration and selling point in marshaling support among partners for reforms in the firm's compensation system. Expect that two, three or more years may be necessary to move from the existing system to a new one.

The nature of compensation makes selection of compensable criteria difficult. A successful law firm needs lawyers with all of the qualities that the various systems attempt to measure. As always, the individual characteristics of the firm dictate how to blend the ingredients into a successful compensation system. It is possible to reduce the emotion and the stress inherent in compensation matters

by understanding that precision and absolute correctness are not attainable. At best, you can create a sense of rough justice wherein the partners are satisfied with the fairness of the system, appreciative of its simplicity, and content to contribute with the knowledge that the pay system will recognize merit. ♦

¹ The author first heard the term 'combustion statements and explosion points' in the book, *Be Our Guest*, by the Disney Institute (Disney Editions, New York, 2001).

James D. Cotterman is a principal of *Altman Weil, Inc.* He can be reached at (610) 886-2000 or jdcotterman@altmanweil.com.



Report to Legal Management

published by:

Altman Weil Publications, Inc.

Two Campus Boulevard, Suite 200
Newtown Square, PA 19073
Telephone (610) 886-2000
FAX (610) 359-0467

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