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Law Firm Compensation Practices Update

James D. Cotterman

By James D. Cotterman

Incisive Legal Intelligence Surveys (formerly Altman Weil Publications®) has released its sixth look at the methods and philosophies of compensation in private law firms: *The Survey of Compensation Programs in Law Firms*. Data was collected during the last quarter of 2008. This article provides commentary on highlights from the partner compensation portion of the study. Further information is available at www.incisivesurveys.com.

In the first survey on this subject in 1993, law firms were almost evenly divided with regard to prospective, retrospective, or combined approaches to when the compensation decision is made. Fifteen years later, a retrospective philosophy prevailed in 41% of the systems, while 35% adopted a mixed (prospective and retrospective) philosophy. The clear loser over time has been the purely prospective approach. This reflects a market-driven need to recognize individual performance more quickly in order to attract and retain 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 and an economy which is visiting shifting economic fortunes upon law firm practices.

According to the *Survey*, the two most important partner compensation criteria in law firms remain the ability to bring new clients to the firm and to be personally productive, as measured by fees collected as a working lawyer. This is consistent with the inescapable truth that successful law firms have consistently high and profitable utilization across all timekeepers. Further, it is imperative that law firm owners possess a keen and well-developed ability to attract profitable business opportunities consistent with the firm's strategic vision. Both of these imperatives are under siege in this economy, depressing law firm profits and in some cases the ability to continue as viable businesses.

Although business origination is consistently ranked as the number one compensable factor, only 56% of the law firms surveyed grant "formal" origination credits. Even though this is a mission-critical skill and the top compensation factor considered, scorekeeping origination continues to be difficult and divisive. Such scoring becomes even more difficult for larger firms where

continued on page 9

Inside This Issue

Chief Legal Officers Don't Think Law Firms Are Serious about Change 2

Dealing with Discord: Time for a Different Approach? 3

Legal Services Procurement 101: The Two-Step Process 7

MergerLine 10

Law Firm Compensation... *continued from cover*

the nature of the client relationship expands across time zones/offices, client business divisions and firm practice groups.

This year's *Survey* delved deeper into the origination credit practices at law firms as well as the issues of collaboration in the selling process. Strikingly few clients are "shared" for origination purposes, which brings into question efforts made to work together to sell services. Further, individual performance drives 64% of compensation decision-making. Next comes overall firm performance at 27% (probably due to its effect on the size of the distribution pool at year-end). That leaves less than 10% weighting to teamwork in practices, departments and offices. If the "talk" is collaborative and encouraging of team behaviors, then clearly the "walk" of compensation is not aligned with those aspirations.

Smaller law firms primarily use an evergreen approach to origination credits, with reallocation primarily to the ambiguous "firm" credit. Larger firms focus more on the connection between who is responsible for the relationship with the client and how that evolves over time. Reallocations are largely a matter of negotiations between partners. We view origination much as the market does — it follows the current relationship. The underpinning of partner mobility is the portability and profitability of the partner's practice. Yet there is room within the context of a firm to recognize the opportunities provided by others.

Subjectivity in compensation decisions generates polarized passions that are more typically reserved for political and religious discussions. Some firms embrace a qualitative approach, while others flatly reject such notions. Nearly one-third of the respondents indicated that no portion of owner compensation is subjective. In addition, just over one-third of respondents indicated that 76% to 100% of owner compensation is subjective. The responses of the remaining 35% of *Survey* participants were scattered between 1% and 75% of compensation distributed on a subjective basis.

The purpose of a compensation program is to produce good decisions. How this is accomplished can and does vary from firm-to-firm. If there is a universal rule with respect to compensation, it is this: every compensation program works and every compensation program fails. Programs run the spectrum from objective to subjective, from participatory to dictatorial. What works well is a program that fits the culture and strategy of the particular firm. The decisions should be consistently and fairly applied (identifying and considering anomalies on a case-by-case basis); reflect overall merit (a basic tenet of any well functioning pay program); and provide for competitive pay relative to the marketplace. Done properly, a compensation program should assist in attracting and keeping the right people in a firm.

Compensation decision-making is generally an annual and open process. This year's study ventured deeper into the make-up of compensation committees to determine how much representational democracy was in play. While the majority answer to whether the compensation committee had proportional representation was consistently "no," there were some interesting differences among the constituencies studied (office, practice area, age tiers, compensation tiers, ownership tiers).

The partner compensation process is a participatory event. Personal interviews are the most common means partners have to provide input. All other forms of input trailed personal interviews. Larger firms are far more likely to have a multi-faceted partner input process that is more fitting to the challenges faced in such large organizations. Larger firms are also more likely to have a special process for firm leadership compensation decisions, again befitting the specialized and unique roles.

Law is a competitive profession. When coupled with a depressed economy, significant likelihood of legislative reforms and wary clients, lawyers struggle with the challenge of dividing a pie that may not be sufficient to satisfy everyone. When dollars are plentiful, it is easy to be generous to all and to satisfy the high producers, but when dollars are tight, internal equity and external competitiveness become increasingly difficult to achieve, especially when the high producers make subtle (and often not so subtle) comments about the inadequacy of their compensation. This is the true test of the firm's values and culture. Unfortunately, in challenging times we all too often find that the bedrock of the firm's existence is compensation and culture and values fall to the side. This is what appears to be happening in many law firms as this severe recession unfolds.

Firms evaluating their compensation programs recognize the dangers of simply maintaining the *status quo*. Key business generators may take their clients and leave; highly talented, technically skilled lawyers may be picked out of the firm; 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. Many firms intuitively understand the risks, but few have the ability to assess that risk in a systematic way. Such risk-assessment tools are available, including one developed by Altman Weil, Inc.

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

continued on page 10

Law Firm Compensation... *continued from page 9*

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 program. 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 program. Mitigation and minimums limit downward adjustments to protect individual personal economic circumstances. This step is a major consideration and selling point in marshaling support among partners for reforms. Generally it will take two or three years to move from an 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 programs attempt to measure. As always, the individual characteristics of the firm dictate how to blend the ingredients into a successful compensation program. 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 program will recognize merit. ◆

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