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The Changing Face of Associate Compensation

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By James D. Cotterman

Associate compensation is changing. Or is it? Many law firms rolled back wages last year, and now some are restoring the reductions. Law firms talked extensively about abandoning the lockstep method of remunerating their associates, yet many new programs appear more like modifications built on a lockstep foundation.

Since 1992, market forces have raised recent graduate starting salaries at an annual compound rate of 6.2%. For the same period inflation increased at an annual compound rate of 2.5%. Thus, starting law school graduates experienced significant real wage growth over the period. There were several reasons:

- Growing demand for graduates with a relatively static supply of new lawyers;
- Annual billing rate increases that patterned the salary increases;
- Clients willing to pay full rates with remarkably little adjustment (efficiency and value were not chief concerns);
- Consistently high utilization driven by work practices that encouraged a high ratio of associate hours to partner hours (even for the first two years of practice).

Then came a great recession and the market changed. The amount of available work diminished sharply and layoffs spread across the profession. Law firms moved aggressively to protect partner profits with overhead reductions, compensation rollbacks, and diminished recruiting with even fewer offer letters and deferred starting dates. It now appears that many of those efforts did, in fact, reduce the potential carnage to partner incomes — at least as measured by profits per equity partner (PPEP).

Pricing constraints were pushed by clients who were themselves under tremendous recessionary pressures. Clients pushed back on the use of first and second year associates on their matters — some even to the point of restricting any involvement unless specifically approved. Value and efficiency became key selection criteria and alternative fee arrangements (AFAs) gained new converts. Make no mistake about it, clients want more efficient services and absolute cost reductions from their lawyers.

One response to these changes has been the introduction of associate apprenticeship programs with the aim to exchange lower compensation for better training and more work-life balance — and to directly link

continued on page 2

Inside This Issue

Law Firm Valuation — Part III 3

Legal Project Management: A Trend at the Tipping Point 7

Compensation ... *continued from cover*

compensation to performance and development. These programs usually include some combination of reduced salary, reduced billing requirements, reduced billable rates, and increased training time. But what are the financial implications of such programs to a law firm's bottom line? Let's analyze an apprenticeship program and compare it to historic law firm associate economics. First we will model the large law firm scenario, and then we will do the same for the profession generally. (See the sidebar on page 11 for an explanation of the data and assumptions behind the model.)

Chart A below illustrates profit and loss on a large firm associate under traditional (historic) and apprenticship programs. The key information using this simple comparative model shows that the apprenticeship program requires a greater economic investment in the new associate, excluding training costs ($550,000 vs. $145,000), longer payback period before associates become profitable for their law firm (six years vs. three years) and lower overall cumulative profits ($810,000 vs. $1,060,000). This is not a pretty picture.

A similar scenario is seen in Chart B for the profession generally. The apprenticeship program uses similar assumptions as the large law firm (BigLaw) program above, but its design details are from a mid-law program's economics. The key information using this simple comparative model shows that profession-wide, an apprenticeship program requires a greater investment ($350,000 vs. $100,000), longer payback period (six years vs. four years) and lower overall cumulative profits ($440,000 vs. $550,000).

All of the most likely variable changes in these models, such as a restoration of the typical 10% rollbacks in salaries or slower rate increases resulting from a shift of pricing power from provider to buyer, yield even less appetizing profit and loss results.

We already know that law firms will go to great lengths to protect PPEP. These apprenticeship programs, if the assumptions play out, will require further adjustments if they are ever to be widely accepted in the profession. While further overhead reductions are possible, they may only come about if the legal service delivery model changes drastically and only then after an investment in re-tooling processes and technology. And while other businesses would likely infuse capital and incur debt for such an investment, law firms are notoriously light in capital and banks are much more careful about lending in the post-recession economy. So that leaves us with only one deep pocket left — PPEP.

As a result, the apprenticeship movement may end up short lived, unless drastically different assumptions can be realistically forecast. All of the levers to push (hours, rates, realization and cost structure) are unlikely to yield much opportunity. Either they are at practical limits already or have limited upside potential or are trending in the wrong direction and are unlikely to reverse course in the near term.

continued on page 10

CHART A

Comparison of Cumulative P&L BigLaw Historic and Apprenticed Associates

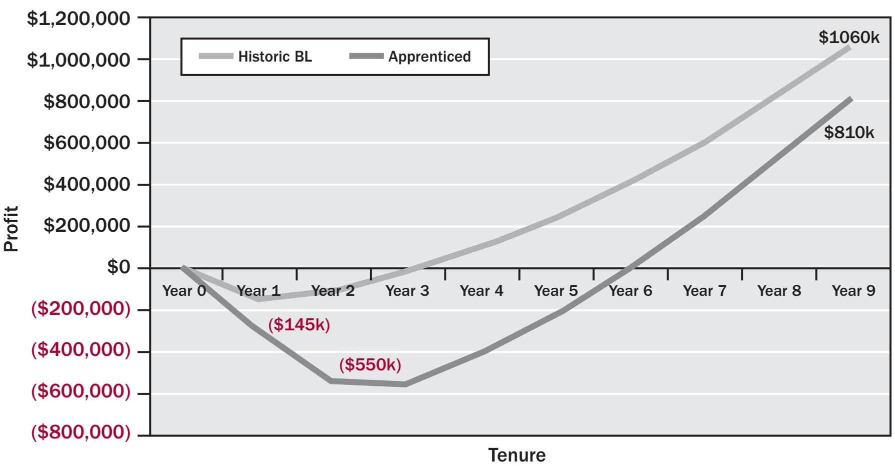
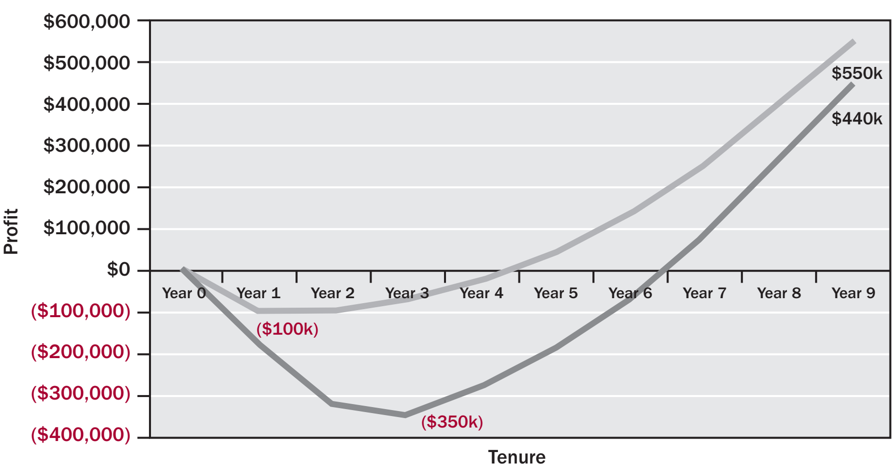


CHART B

Profession Cumulative Profit (Loss) on Associates



Compensation ... *continued from page 2*

It is the author's view that an apprenticeship model only works if three factors change.

1. First, leverage must expand in a very major way — to levels more typically associated with large public accounting firms. This would require a radical restructuring of how services are delivered. And this expanded leverage would not look like it has in the past with legions of expensive associates working long days and nights, but rather would be constituted from an increased use of paraprofessionals and outsourcing. If this were to occur it would set up the second requirement.

2. Apprenticeship programs would be available to much smaller associate classes than typically are associated with firms of any size. This would reduce the inherent investment these programs require on a per person basis.

3. Finally, productivity must significantly increase. This does not mean working more hours; rather, it means getting more work done in each hour. This will most likely be driven by a radical shift in how legal services are managed and delivered, and by more alternative fee arrangements.

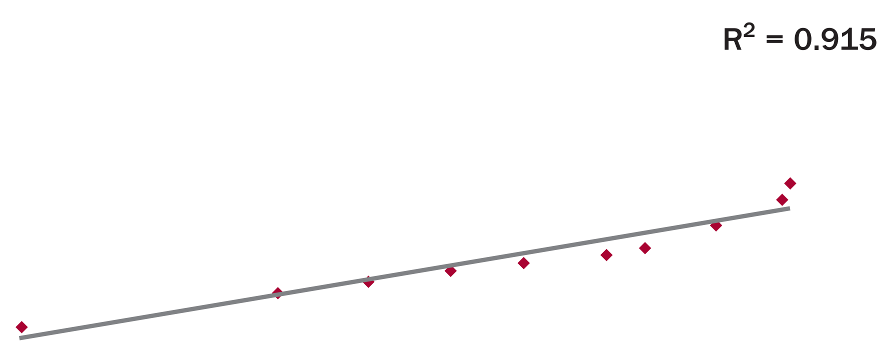
So what's next? The desire to link associate compensation to performance is positive. But is it a real change? Let's return to the abandoned lockstep associate compensation programs for a moment. Much has been said regarding how such programs do not reward performance. A review, unfortunately, does not support that conclusion.

"The desire to link associate compensation to performance is positive. But is it a real change?"

Below, Chart C shows the relationship of associate compensation and time value recorded for the first ten years of an associate's career. Let's accept that the critical financial contribution of an associate is collected fee dollars. Further, let's accept that time value recorded is a reasonable proxy for collected fees in most situations. Theoretically, adjustments to time value would lower fees, but research shows such an adjustment does not alter the relationship to compensation. If we graph compensation and time value recorded and look for the strength of the relationship between the two variables, we get Chart C. This chart indicates that 91.5% of the variablity in an associate's pay is explained by the variability in an associate's recorded time value. It also indicates that all other factors affecting compensation explain only 8.5% of the variability in compensation. That appears to be fairly well tied to finanical contribution.

CHART C

Relationship Between Associate Compensation and Time Value Recorded



Relationship Between Associate Compensation and Time Value Recorded

How did firms manage this close correlation if the lockstep compensation program is so misaligned with performance? Granted, the salary increases were pretty automatic. However, most firms also incorporated significant bonuses in their programs that were tied to exceeding certain thresholds in hours (a proxy for fees) or fees themselves. This went a long way to ensure compensation reflected contributions. In addition, 40% of associates were gone by year three and 62% by year four. So a weeding out process, no matter how or why, substantially increased the probability that those continuing on would meet the performance expectations contemplated in the lockstep compensation program. Admittedly this may not be ideal, as there are plenty of opportunities for specific circumstances where a mismatch could occur. But systemically the traditional lockstep program appears to reflect merit.

Nonetheless, changes are being made. So whether a new compensation scheme is an entirely skills and competencies based program, a modest lockstep salary with a robust bonus, or a multi-tier program, associate compensation is changing to reflect a different market.

What do law firms want to accomplish with these changes? First is a greater emphasis on skills and competencies, rather than class year experience, in establishing pay. This is a very good step forward for everyone — associates, law firms and clients. Second is the flexibility to promote as warranted and needed. This works better for those associates who progress faster (no resentment at slower pay recognition) or slower (less pressure to catch up) than normal. But it also means that the firm could defer promotions if it does not perceive a need for a higher level of associate in a given office or practice area. Accordingly, greater experience, skill and competency will be required for promotion, but together they will not be sufficient for promotion. Thus the associate becomes the bearer of market risk, just like the employee is the bearer of market risk in a defined contribution retirement plan. And also like the disappearing defined benefit pension plan, the defined associate career track, where only the law firm accepts the market risk, is going to disappear.

Here are five actions items to consider for 2010:

1. Evaluate your associate's economic profile by class as shown above and overall to determine the profit margin they contribute to the firm (the latter is especially important as we have seen an uptick in profit challenges among this group of timekeepers).
2. Determine the relationship between associate pay and performance at your firm. What are you trying to achieve and how close are your decisions to achieving those ends?
3. Invite associates into the discussion about their pay program. Their insights can be extremely useful and it gives you a solid understanding of their concerns and expectations. If you do so, however, then be ready to respond to the issues they raise.
4. Create pilot programs where features of any program changes can be test driven and refined to avoid unintended consequences.
5. Model major undertakings such as apprenticeship programs as shown above, but include your estimates of savings from changes to recruiting and summer programs as well as additional costs for the enhanced training programs.

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About the Model

The author's model examines the first nine years of a lawyer's career. Historic data and class profiles are used to develop a cash basis profit and loss picture. Billable hours and rates per year are used to construct the value of time recorded. Data on unbilled time lock-up and billing realization are used to prepare annual billings, as are data on fees receivable lock-up and collection realization to prepare annual collections. Expenses are developed from overhead and total compensation data. The profiles include adjustments for inflation and experience.

Developing the apprenticeship comparative included both design elements and assumptions of the consequences of the design elements. The apprenticeship model examined has the following design elements:

1. Billable hours – 500 in year one, 1,000 in year two, revert to historic thereafter.
2. Billing rates – half of historic for years one and two, revert to historic thereafter.
3. Compensation – based on stated salary and bonuses for years one and two, revert to historic thereafter.

In addition, the author made several assumptions:

1. The 10% across the board salary reductions would continue.
2. Realization improves dramatically in years one and two to reflect increased client acceptance at the new utilization and rates and remains two percent better than historic from then on.
3. Cost of the apprenticeship program (the additional training and mentoring) is offset by the reduction of expenditures on recruiting and summer programs. ◆