Partner Compensation Systems in Professional Service Firms Part I

By Edge International

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Before you overhaul your firm’s compensation system, consider this analysis of the strengths and weaknesses of the most common systems used in professional service firms. And keep in mind the basic truths about compensation…

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In our work, we are exposed to a variety of methods used by professional services firms, particularly lawyers and accountants, to divide partnership profit. We have found that almost all compensation systems fall into seven basic categories—or variations of these categories:

1. Equal Partnership
2. Lock-Step
3. Modified Hale and Dorr
4. Simple Unit
5. 50/50 Subjective-Objective
6. Team Building
7. Eat What You Kill

BASIC TRUTHS ABOUT COMPENSATION SYSTEMS

If your firm is considering anything from a minor adjustment to a major overhaul of your compensation system there are some basic truths that you should keep in mind.

There is no magic system that will satisfy all partners, meet all strategic goals and never need to be changed. All professional service firms must realize that a compensation system is a living and breathing beast. It will need to change or adjust to meet the demands of changing times—either to satisfy partner concerns or to complement and reward compliance with ever-changing firm goals. (And we all know that the only constant in professional life today is change.) Try as you might, some people will always think you are singling them out for a smaller piece of the pie. The best you can hope for is that most will view the system as relatively fair.

A compensation system should be related to your firm’s strategic goals. For example, if you think that the mentoring of juniors is a worthwhile pursuit, then you had better have some form of reward for it in your compensation system or the message to your partners is that it is valueless and will only be done through their altruism and sense of teamwork.

Every type of compensation system has compelling reasons for adoption, or strengths, and often just as compelling reasons why it should not be adopted, or weaknesses. While a system might deal handily with partner concern A, it might have a reverse effect on partner concern B. For example, a system that rewards rainmakers might solve the concern of those partners most responsible for bringing in the work. If, however, the system does not reward the partners who take responsibility for those clients, you will offend a vital group of partners. You can bring in all the work in the world, but you will not improve your profitability if no one takes responsibility for the clients. The reverse is also true: The partners who are capable client managers will have nothing to do unless the rainmakers bring in the clients.

A fair system can only be created when all those affected openly discuss the strengths and weaknesses of any proposed scheme. This type of brainstorming session is the only way to get the issues out and dealt with in appropriately. In very large firms, each interest group in the partnership might send a representative to such a session, as opposed to asking every partner to attend and participate.

Of course, some firm leaders may think they can solve all of their compensation system problems and arguments by hiring a consultant who will meet with every partner and then create a report that will be acceptable to all. We relate this type of consulting to one of our favorite little stories:

They saw the consultant like a seagull flying in from afar. It circled their heads and dropped something white in their
hands. They thought it was a report. Only after the seagull had disappeared from sight did they discover what it really was.

K.I.S.S. (Keep It Simple Stupid). A compensation system that leaves most partners scratching their heads over the calculation of their individual compensation is doomed to fail. You may think it is straightforward, but be sure others agree with you.

THE SEVEN BASIC COMPENSATION PLANS

The following are the seven basic compensation plans in use by professional firms around the world, along with analysis of their strengths and weaknesses. Most firms employ a variation of one or another of these.

1. The Equal Partnership

This system is typically used only by smaller firms. Basically, all partners share in profits equally or equally within defined groups of partners. Here is a simple example. In a firm with eight partners that are divided into four senior partners and four junior partners, the senior partners equally share 60 percent of the firm’s total profits (15 percent each), while junior partners equally share 40 percent of the firm’s total profits (10 percent each). In a more complicated version, various levels of partners may share equally, but partners may move from one group to another each year—up or down, depending on their performance.

There is an underlying assumption that all partners are contributing to the overall firm performance equally, albeit in different ways. Some do it through their billable performance while others do it through non-billable contributions. It is usually when this assumption of equal contributions no longer appears to be true that the partnership starts to look for a fairer compensation system.

Strengths

In an equal partnership, the bigger the pie, the bigger a partner’s share of profits. Therefore the paramount financial concern is firm profitability. Individual performance is much less important than how well the firm does as a whole. As long as the firm does well, then the individual partners will do well. This allows for individuals to have performance swings—up years and down years—as long as overall the firm does well. Usually, performance is measured over a longer term basis, say three to five years, as opposed to limiting compensation criteria to a single year’s performance.

Because individual performance is less important than overall firm performance, equal partnerships tend to be a great deal more collegial than partnerships that place more emphasis on individual numbers. This, in turn, allows partners to focus their competitive instincts externally rather than internally. The question shifts from how I outperform my partners to how we outperform other firms. Some firms choose the equality system because they find the whole pie splitting exercise—complete with finger pointing—to be repulsive. There is much to be said for avoiding the conflicts and internal bickering that develop in many firms at compensation time.

Another strength is that partners have a certain sense of security as to what their income will be in any given year or at any given time during that year. This, of course, reduces the amount of schizophrenia most partners feel when thinking about compensation. They don’t fret over questions like Are my numbers good enough? or Did Joe do better than me? or Will my non-billable efforts really be recognized?

In such a system most partners work well together. They do not hoard either clients or files because their goal is to increase the total profit pie, not their own numbers. This sounds pretty good, doesn’t it? Unfortunately, there is a downside too.

Weaknesses

Equal partnerships face some very serious problems, mostly having to do with incentives or, more properly put, a lack of incentives. There is no financial reason or reward for the individual partner to push beyond normal partner performance levels. There is seldom much of an individual financial difference between the partner who works 12-hour days and the partner who plays golf most afternoons. There is no perceived or real value in working harder.

This lack of incentives can lead to resentment of those partners who are viewed as lazy or underachieving. If not promptly dealt with, this resentment can lead to a serious erosion of the collegiality that an equal partnership strives so hard to develop.

What’s more, those partners who are more profitable, who put in more hours, bring in more clients or make valuable non-billable efforts will soon do more than merely resent those partners whom they perceive as doing less. They will leave to join firms where they feel their efforts are more appreciated and better rewarded in the financial sense. The impact of the most profitable partners leaving an equality firm can be devastating. Eventually only the poorer performing partners remain,
profitability declines and the partnership dissolves because there is no point in staying together as a firm. The death knell is sounded because the firm is then only as good as its lowest common denominator or weakest link.

To avoid resentment among partners and maximize profitability, leaders of most modern firms will tell you that there must be at least some sense that individual efforts will be recognized and rewarded.

2. The Lock-step System

The lock-step system is used by a fair number of firms that are organized in a traditional fashion. The basic concept is that each partner is rewarded an ever-increasing share of the firm’s profits, based solely on seniority. The longer a partner remains with a firm, the more money the partner will make.

In a lock-step system, income can be divided exactly along seniority lines or, as with the equality compensation system, divided into levels. For example, the divisions might be senior partners (more than 15 years as a partner), middle partners (5 to 15 years as a partner) and junior partners (1 to 5 years as a partner).

Strengths

The greatest financial rewards in a lock-step compensation system go to those partners who have stayed with the firm for the longest time as a reward for their years of service to the firm. This obviously gives the firm, and probably the management of the firm, a great deal of stability. Few partners, once committed to a Lock Step system, would leave before they had risen to the top of the compensation totem pole.

Partners also have a sense of security from knowing that their share of the profit pie is pre-set. The only variable then becomes how big the pie will be. This security can help to create a more collegial atmosphere among the partners.

Like the equality system, lock-step encourages external competition rather than internal competition among partners because the only way to increase individual incomes is by making the overall pie bigger. With no divisive compensation meetings and no internal compensation competition to deal with, many of the partners will expend their energies trying to make the total profit bigger so that everyone makes more money. There is no financial advantage to file or client hoarding among the partners so they tend to work well together, again contributing to the collegial atmosphere.

Weaknesses

Like the equality system, lock-step does not directly reward individual contributions and initiatives. As a result, some partners will not expend extra effort when they know that all they need do is contribute at a normal rate to keep progressing along the compensation path.

This lack of financial incentives can have a great impact on a firm’s profitability because, in some cases, it is actually a demotivator. Why bother? In some firms the motto is, You get what you pay for. Obviously, a lock-step firm cannot accept that kind of thinking if it is to succeed.

In many firms with a lock-step system, the younger partners feel a great deal of resentment by toward the senior partners. Often the attitude of these younger partners is, What have you done for us lately? Too often they see senior partners who have slowed down but still command the largest share of firm profits. As one partner said, He has retired but has just failed to tell the rest of us. That kind of resentment cannot be good for any firm. Eventually it will harm profits and collegiality.

In lock-step firms where senior partners are perceived to be taking more than their appropriate share of profits, there will eventually be an exodus of the younger, hard working partners. They will move to firms that are prepared to recognize and reward their efforts. The result for the firm is lower profits at best, and at worst, disintegration.

Some firms have tried to address this problem by increasing the percentage share of profits each year, but only to a certain level. After a certain point, the percentage starts to drop. For example, each partner may progress until reaching the age of 55 or 60, when their income slowly starts to drop as they prepare for their retirement at 65 or later. The thinking is that most partners reach the peak in terms of willingness to put in the hours and ability to generate profits somewhere between the ages of 45 and 55.

Other firms have tried to address this same problem by setting a maximum number of points a partner can accumulate so that the most senior partners don’t continue to amass ever-increasing shares of the firm’s profits simply by growing older. Rather, they level off at a certain point so that many more of the partners become equal, at least in terms of compensation, at an earlier age.
David Maister, has expounded on the concept that intolerant lock-step is a viable way of distributing profits. He says that for a lock-step system to work, it must be intolerant of partners who do not meet enunciated expectations. If partners are allowed to under-perform, the system cannot succeed. He cites Skadden Arps as an example of a law firm that uses this method successfully.

3. Modified Hale and Dorr System

Back in the 1940s, the Boston law firm Hale and Dorr created what is regarded as the first incentive-based compensation system. The firm created three categories in which a partner could earn income: Finder (originator of the client), Minder (responsible for the client) and Grinder (the partner actually doing the work). Over the years, this system has been adopted by many professional service firms. The system has evolved, of course, but the basic premise remains the same.

An example of the Modified Hale and Dorr system might be:

- 10 percent of profits to the finders
- 20 percent of profits to the minders
- 60 percent of profits to the grinders
- 10 percent of profits to a discretionary pool, which is allocated at year’s end to the partners who have shown exceptional performance.

These percentages can be adjusted each year to address issues that the firm determines are the most important for the coming year. As an illustration, a firm may choose to lower the finder category’s percentage if it has plenty of good work coming in, and increase either or both of the minder and grinder categories so that people will focus on getting the work done. The following year the focus may shift and percentages can be adjusted to reflect those changes. This makes the system adaptable and flexible.

**Strengths**

This modified Hale and Dorr system is much better at rewarding the contributions of the individual partners than the equality or lock-step systems. The system places much more value on individual contributions and much less value on what the firm does overall. The clear assumption is that if everyone is motivated by the compensation system, the firm as a whole will do just fine.

Partners know exactly what they have to do if they wish to increase their income. Many partners prefer such a system because it allows them to become the masters of their own financial destiny, either higher or lower depending on personal goals. For example, this system allows the partner who wants to spend more time with his children while they are growing up to slow down for a few years. He may do so and be assured that while his income may be less, his decision should not affect his partners and they should not resent him. In a few years, the same partner may realize that the best thing for him is to bear down and generate more income for his children’s college education and for his own retirement. This system allows that kind of increase or decrease in efforts and contributions because it only rewards success and hard work.

Under this system there is much less bitterness toward a partner who is perceived to be making less of a contribution to firm profitability because when they contribute less, they receive less. Of course a partner who performs well below normal expectations will still have problems. This person may, in fact, be asked to shape up or ship out. Tolerance will only go so far.

Seniority has no direct value in compensation under the modified Hale and Dorr system, though a more senior partner would probably bill at a higher rate and therefore command a larger percentage of the grinder share of the profits when doing the same amount of work as a younger partner.

An objective system such as this greatly reduces the amount of pie splitting animosity that can develop under other systems. Partners have a good idea of what they will earn by applying the formula to their statistics at any time during the fiscal year. The only variable is the discretionary pool. However, because the pool is relatively small and the outstanding contributions are usually quite obvious to all, few arguments and hostility result.

**Weaknesses**

The modified Hale and Dorr system does a good job of taking care of the billable time rewards. Unfortunately, no rewards are built in for non-billable time, except perhaps through the bonus pool (and that is not the purpose of such a pool). If all partners equally share all the non-billable activities required in a professional service firm, then there would be no problem with this type of compensation system. However, most professional service firms do not equally divide responsibility for firm management, training or mentoring of juniors, practice group leadership, recruiting or committee work. So where is the motivation to use time for these important aspects of running a profitable firm?
Given the choice, partners will always opt for the billable work ahead of the non-billable work. As a result, this type of system can create more a firm of individuals rather than a firm of team mates. This is not a contributor to firm collegiality. In fact, often the opposite is the result. Partners become so concerned with their personal numbers and income, little time or effort gets expended on the type of activities that build teams and collegiality.

In addition, because partners are paid only for their production, many make the mistake of hoarding clients and work. Their thinking is that 60 percent as the grinder is a lot more than 10 percent as the finder. This can lead to resentment by the other partners, and to liability risks when a partner performs work in areas in which they are not proficient. It is demoralizing as well to the juniors who are not getting enough work—or enough quality work.

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