

Pros and Cons of Partner Compensation Systems: Which One Is Right for You?

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Before overhauling your firm's compensation system, consider the strengths and weaknesses of the most common systems used in professional services firms. And factor in the dynamics of partner interactions and collegiality.

Professional services firms use a variety of methods to divide partnership profits, but almost all compensation systems fall into seven basic categories, or variations of those categories. Each type of system has compelling reasons for adoption, and often equally compelling reasons why it should not be adopted. While a system might deal handily with partner concern A, it might adversely affect partner concern B.

The following describes the seven basic compensation plans, including an analysis of the strengths and weaknesses of each. If your firm is considering anything from a minor adjustment to a major overhaul of its system, keep these pros and cons in mind.

And remember, there is no magic compensation system that will satisfy all partners, meet all strategic goals and be effective for all time. A compensation system is a living, breathing beast. It needs to be adjusted regularly to meet the demands of changing times—either to satisfy partner concerns or to complement compliance with the firm's strategic goals.

1. The Equal Partnership System

In this system, typically used only by smaller firms, all partners share equally in profits. Or, they share equally within defined groups of partners. For example, an eight-partner firm has four senior partners and four junior partners. The senior partners equally share 60 percent of the firm's total profits (15 percent each), while the junior partners share 40 percent of the profits (10 percent each). In a more complicated version, various groups of partners may share equally, but partners may move from one group to another—up or down—depending on their performance each year.

The underlying assumption is that all partners are contributing equally to the firm's overall performance, albeit in different ways. When that assumption no longer appears true, it is usually time for the partnership to look for a fairer compensation system.

Strengths. In an equal partnership, the bigger the pie, the bigger each partner's slice of the profits is. Therefore, the paramount financial concern is firm profitability. As long as the firm does well, individual partners will do well. Because this allows for individual performance swings, performance usually is measured over a longer-term basis, say three to five years, as opposed to limiting compensation criteria to a given year's efforts.

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 enhanced collegiality, in turn, allows partners to focus their competitive instincts externally, rather than internally. The challenge shifts from "how I outperform my partners" to "how we outperform other firms."

Another strength is that partners have a certain security regarding what their income will be in any given year, or at any given time during the year. Partners needn't fret over whether or not their numbers are "good enough."

Weaknesses. Equal partnerships face some serious problems, mostly relating to incentives or, more properly, a lack thereof. There is no financial reason for an individual to push beyond normal partner performance levels. There is seldom much difference in compensation between the partner who works 12-hour days and the partner who plays golf most afternoons.

This can lead to resentment of those who are viewed as underachieving or lazy. If not promptly dealt with, such resentment can seriously erode the collegiality that an equal partnership strives so hard to develop.

What's more, those partners who are more profitable, put in more hours, bring in more clients or make valuable non-billable efforts will soon do more than merely resent other partners. They will leave to join firms where they feel their efforts are more appreciated and better compensated. Eventually, only the poorer performing partners will remain, profitability will decline and the partnership will dissolve because there is no point in staying together as a firm. The death knell sounds when the firm is only as good as its lowest common denominator.

2. The Lock-Step System

Many traditionally organized firms use the lock-step system. The basic concept is that each partner is awarded 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 makes.

Income can be divided exactly along seniority lines or 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 lock-step reward for years of service obviously gives the firm, and probably its management, a great deal of stability. Once committed to this system, few partners want to leave before they have risen to the top of the compensation pole.

Partners also have the security of knowing that their share of the profit pie is preset. The only variable is the size of the pie. This security can help to create a more collegial atmosphere.

Like the equality system, the lock-step encourages external—rather than internal—competition because the only way to increase individual incomes is to make the overall pie bigger. With no divisive compensation meetings or internal compensation competition, many 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.

Weaknesses. Because the lock-step does not directly reward individual contributions, some partners will not expend extra effort when they know that they need only contribute at a normal rate to progress along the compensation path. Why bother, those partners will ask. Obviously, a lock-step firm cannot tolerate that kind of underperformance if it is to succeed.

Also, younger partners may greatly resent senior partners. Too often, junior partners 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." This resentment will harm profits and collegiality.

Moreover, when senior partners are perceived to be taking a disproportionate share of profits, there will eventually be an exodus of hardworking younger partners. They will move to firms prepared to recognize and reward their efforts. The result for the firm, at best, is lower profits and, at worst, disintegration.

Some firms try to address this problem by annually increasing the percentage share of profits only until it reaches a certain level. After that, the percentage starts to drop. For example, partners may progress until

reaching the age of 55 or 60, when their income slowly drops as they put in fewer hours at work and prepare for retirement at age 65 or later.

Other firms have 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 many more of the partners become equal, at least in terms of compensation, at an earlier age.

3. Modified Hale and Dorr System

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" (partner responsible for the client) and "grinder" (partner actually doing the work). Over the years, as other firms have adopted this system, it has evolved. But the basic premise remains the same.

As an example of a modified Hale and Dorr system, a firm might allocate 10 percent of profits to the finders; 20 percent of profits to the minders; 60 percent to the grinders; and the remaining 10 percent to a discretionary pool, which is allocated at year's end to the partners who have shown exceptional performance.

These percentages can be adjusted annually to address the firm's priorities for the coming year. For instance, if the firm has plenty of good work coming in, it may choose to lower the finder category's percentage and increase the grinder's percentage so the focus is on getting the work done. The system is adaptable and flexible.

Strengths. Compared to the equality or lock-step systems, the modified Hale and Dorr places much more value on individual contributions and much less 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.

Seniority has no direct percentage value. Partners know exactly what they have to do if they wish to increase their income: Be more productive. Many partners prefer such a system because it allows them to become the masters of their financial destinies, making higher or lower income depending on individual goals. For example, if a partner wants to slow down for a few years to spend more time with growing children, that partner is assured that, while his income may be less, his decision should not affect the other partners financially. Because this system only rewards productivity and success, it allows for this kind of increase or decrease in efforts at given times.

As a result, there is much less bitterness toward a partner who is perceived to be contributing less to firm profitability. When partners contribute less, they simply receive less. Of course, a partner who performs well below normal expectations will still have problems. Tolerance can only go so far.

An objective system such as this greatly reduces the amount of pie-splitting animosity that can develop under other systems. The only variable is the discretionary pool. However, because the pool is relatively small and the outstanding contributions are usually obvious to all, few arguments and less hostility result.

Weaknesses. Unfortunately, this system has no built-in rewards for non-billable time, except perhaps through the bonus pool (and that is not the purpose of such a pool). Therein lies a problem, because most 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 expend time on these important aspects of running a profitable firm?

Given the choice, partners will typically opt for billable over non-billable work. Therefore, this type of system can create a firm comprised more of individuals than of teammates. In fact, partners can become so concerned with their personal numbers that little time is expended on activities that build collegiality.

In addition, because partners are paid primarily for their personal production, many make the mistake of hoarding clients and work. This can lead to resentment, and to liability risks when partners perform work in areas in which they are not proficient. It also is demoralizing to junior lawyers who simply do not get enough work—or enough quality work.

4. The Simple Unit Formula

The simple unit formula is designed to reward seniority, production, client generation and non-billable activities. It uses a relatively straightforward and totally objective calculation. Under a typical formula, each partner might receive one unit/point for each year with the firm, one unit/point for \$x of production (fees billed or fees received) and one unit/point for \$2x of client generation.

The non-billable units/ points are awarded on the basis that the total available number of units/points is three times the number of partners. Then those available units/points are allocated on a pro rata basis for non-billable time recorded. When all the units/points have been allocated, they are converted to percentages and applied to the net firm profit for the fiscal year to create each partner's individual income.

Strengths. Similar to the modified Hale and Dorr system, this formula mainly rewards actual contributions in an objective manner. The biggest differences are that the simple unit formula also rewards longevity with the firm as well as some non-billable efforts, at least to some degree.

Because production is at the heart of this scheme, there is less bitterness toward those partners who may be considered underproducers or low-profit contributors. Partners' rewards will be less if their production is lower.

Probably the greatest strength of the simple unit formula is that it lives up to its name. It is simple. It is a straightforward calculation that partners can readily understand and compute. All partners know exactly what they have to do to earn their desired income, and at what level all the factors are weighted.

Weaknesses. The major drawback is that the formula can promote hoarding of clients and files. Individual partners want to make their numbers, and on a personal income level, there is little value in delegating work. Obviously, a system that encourages hoarding results in less collegiality, and the competitive focus can become internal, rather than external.

The units/points that are awarded for seniority can cause animosity among the younger partners as well. This also may become a serious impediment to lateral hiring, since new partners would start at zero points/units in the seniority factor, compared to peers in the same firm.

5. The 50/50 Subjective-Objective System

The 50/50 subjective-objective system attempts to overcome the problems associated with systems that are too objective or too subjective. It recognizes that both types of criteria are valuable to the firm as a whole.

The scheme's objective part has two components: 40 percent of partner income is based on actual billings or receipts, while 10 percent of income is based on actual client-generation statistics. However, these percentages can be varied according to a firm's vision of what compensation should reward, and what weight it wishes to give the individual criteria within its system.

The scheme's subjective portion is based on all the partners' perceptions of two other criteria: 10 percent is based on the perception of a partner's client handling abilities, and 40 percent is based on the perception of all other criteria. Again, these percentages can be varied.

In large firms, all partners may not have enough knowledge to accurately rate some fellow partners in the subjective criteria. So some firms have opted to leave that part of the plan in the hands of the specific departments or practice groups—where the lawyers are in the best position to evaluate another partner's contribution subjectively.

Strengths. With 40 percent of the subjective portion allocated to almost any strength a partner brings to the table, there is usually much less animosity and more collegiality within a department, practice group and firm. This purposely undefined share of income can be used to reward unusual non-billable efforts, firm management, training of juniors, mentoring, being a team player, attempts at client generation that do not materialize immediately, or simply being a nice person and an overall asset to the partnership.

This same 40 percent can also be used negatively. Awarding a low percentage can send a message to partners that they are not perceived as positive contributors to the overall firm or group—even though they may have very good objective numbers. Negative factors that can thereby adversely affect a partner's income are: file or client hoarding, being too demanding of staff and juniors, not contributing to firm initiatives, not complying with firm policies, not taking the time to properly train juniors or just being an all-around pain.

Many like this system because it allows for individual partner input into compensation through the plan's subjective portion. However, for those partners who demand that compensation be tied to actual performance, one half of remuneration is still based solely on the objective number for billings, receipts and client generation.

Weaknesses. Partners who dislike this system say it provides insufficient specifics on what is needed to meet personal income goals. Others see the subjective portion as too "touchy-feely." They want a more objective scheme that ties bigger rewards to actual production. There is the chance of animosity developing over the allocation of the subjective portion. This can become divisive when compensation decisions are not properly and positively conveyed to every partner. There can also be some resentment aimed at partners who fail to meet objective-criteria expectations but are able to overcome that shortfall through the subjective criteria.

Perhaps the biggest argument against this system is that, if not properly explained and implemented, the subjective criteria might be seen as open to manipulation when they are not backed up by some form of data, such as a partner-peer evaluation system.

6. The Team-Building System

This is the ultimate team system of compensation. Individual contributions are given little consideration, while firm profitability and practice group or department performances are paramount. The formula for the team-building system bases 50 percent of a partner's compensation solely on how well the firm does financially. Another 40 percent is based on a practice group's or department's financial performance. The remaining 10 percent is based on individual performance. These percentages can be varied to suit a particular firm's vision of how each area should be weighted.

Strengths. Simplicity may be the greatest strength of this system. It is totally objective and downplays the role of the individual. There is little pie-splitting animosity because all partners in a group or department will sink or swim based on their collective efforts. When everyone pulls together, they all succeed to higher levels. And, again, the competitive focus is external, rather than internal.

Cooperation and collegiality at the group and firm levels are the cornerstones of a team-building system. This requires a partnership of individuals who are comfortable with one another, and who have faith in one another to always do what is best for the team—to willingly waive individualistic tendencies when they conflict with team goals.

Firms using the team approach seldom experience file and client hoarding. Delegation is usually at a high level because it is in everyone's best interests to push work to the lowest competent level. This provides better value to clients, training for junior lawyers, challenges in professional development and greater job satisfaction all around.

In turn, those results positively affect firm profitability, thereby perpetuating the system of teamwork. There is also greater cooperation across departments and practice groups because that, too, can help improve profitability.

Weaknesses. Some partners may feel that there is a lack of recognition for seniority and experience. Unless there are levels of partners created within the system, all partners would earn close to the same amount. The only variable then is the relatively small 10 percent that is allocated for individual production.

Some animosity may develop toward partners who are perceived as being the weak links in a department or practice group. However, a firm can act on the weak links by setting minimum standards for all partners—standards that do not tolerate lengthy periods of underachievement. Lastly, individuals who make large contributions may well leave for a firm that will reward their efforts more highly. Some, in fact, argue that this system promotes a "lowest common denominator" approach. That is, partners won't make enough of an effort to perform at a level above others because they don't see the direct rewards of doing so.

7. The Eat-What-You-Kill System

In direct contrast to team building, the eat-what-you-kill system rewards individual efforts exclusively.

One form of this system, for example, charges each partner a share of firm overhead, but each partner pays the salary of his or her secretary. Individual marketing, continuing education, personal technology and membership costs are each partner's responsibility. Junior lawyers' time is "purchased" from the firm at set rates, but charged out to clients at whatever billing rate the partner deems appropriate. Partners can also sell an interest in a particular file to another partner at a negotiated rate. Having dealt with all the costs, the partner then keeps 100 percent of all receipts.

Strengths. Every partner has total responsibility for his or her income and clients. There can be no blaming anyone else. There are various levels of incentives in this system. First, partners will want to bring in business for others because they get a percentage of the billing when they "sell" the file to another partner, or when they get a junior to manage the file. Also, there is incentive for hiring and retaining only profitable, hardworking juniors so partners can maximize their own incomes. Partners are strongly motivated to collect their receivables because it is their own money. Lastly, the firm will maintain tight controls on spending because partners will not tolerate too large of an allocation to overhead.

In addition, there is no animosity related to pie splitting, because there is no pie splitting.

Weaknesses. Probably the greatest weakness is that, in most cases, there is a total lack of responsibility for managing the entity. Because no one gets recognition for non-billable time, there is often a void when it comes to firm management, training of juniors, firm marketing or human resources. (Junior lawyers find themselves in a sink-or-swim situation right from the start.) Such a void will inevitably lead to major problems, and possibly disbanding of the firm.

This system offers no impetus for collegiality. Often partners don't even talk to their colleagues unless they have a financial or personal reason to do so. That, in turn, creates a very difficult work environment for staff, juniors and even some partners.

In addition, the work-sharing aspects present problems. A partner may choose not to work for another partner's clients for myriad reasons, leaving originating partners to fend for themselves in an area in which they may lack proficiency.

As for hoarding clients, that's what this system is all about—sometimes to the client's detriment. Few "common good" factors are at work because individual good is paramount.

What Is the Highest Value?

Are you wondering which, if any, of these systems would work best for your firm? Before you can develop a successful compensation system, you must clearly understand—and agree on—what the firm values most, and why.

You must also gain a true reading of what your partners do and do not want in a compensation system. A fair system can be created only when all those affected openly discuss the strengths and weaknesses of any proposed scheme. Yes, try as you might, some people will always think they are being singled out for a smaller piece of the pie. You may, though, be surprised at how agreeable most partners are once they have made their points of view known, and considered their colleagues' perspectives. Finally, keep it simple. Remember that a 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.

Simple Unit Formula

Sample compensation breakdown:

- 1 unit/point to each partner for each year with the firm
- 1 unit/point to each partner for \$x of production
- 1 unit/point to each partner for \$2x of client generation
- Non-billable units/points are allocated on a pro rata basis for non-billable time recorded

50/50 Subjective-Objective System

Sample compensation breakdown:

- 40% of each partner's income is based on actual billings or receipts
- 10% of each partner's income is based on actual client-generation statistics
- 10% of each partner's income is based on other partners' perceptions of the individual's client handling abilities
- 40% of each partner's income is based on other partners' perceptions of all other criteria

Modified Hale and Dorr System

Sample compensation breakdown:

- 10% of profits to the partners who originate clients
- 20% of profits to the partners responsible for the clients
- 60% of profits to the partners who actually do the client work

10% to a discretionary pool, allocated to those partners who perform exceptionally

Team-Building System

Sample compensation breakdown:

50% of each partner's income is based solely on how well the firm does financially

40% of each partner's income is based on the practice group's or department's financial performance

10% is based on the individual's performance

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