IS YOUR COMPENSATION SYSTEM STILL WORKING PROPERLY?

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I have no doubt that the title of this article got your full attention. Nothing is as near and dear to an attorney's heart as compensation. And nothing strikes more fear for most than a possible change to the manner and method of calculation for distribution of firm profits.

In the context of this article, I'm referring to owner compensation, not compensation for associates, paralegals, or support staff. I am also not referring to compensation for non-equity partners. Some of you call it compensation, some call it salary, still others call it draw. Call it what you will. For equity owners at properly managed firms, it's nothing more than a share of profits.

Note the caveat about properly managed firms. Let me make a strong opinion of mine clear at the outset. Owners of firms are paid from the firm's profit. If there is no profit, there can be no compensation. If there is insufficient profit, compensation must be lowered. Firms which dip into lines of credit or borrow in order to pay owners compensation, in the absence of profit, are skiing off the top of a cliff onto a steep slippery slope, from which one should never expect a soft landing.

I have noticed an increasing volume in a number of indicators of faulty compensation systems, on a statewide basis. It has me worried, because I don't think firms are addressing it adequately, or for some, at all. There could be any number or reasons why including

- Lack of recognition that the system may not be working in the current firm environment, especially if it has worked well in the past

- Lack of ability to locate and analyze the data necessary to light the path to solutions

- A strong reluctance to seek outside assistance because it would mean opening the books, being honest about ones opinions, and discussing sensitive issues

- Fear —what one knows is better than the unknown

- Fundamental lack of agreement on what should be rewarded – objective factors such as client origination and hours worked; subjective factors such as leadership, marketing, mentoring; or a combination

- Fundamental lack of agreement on the firm's culture as it relates to compensation, e.g. all-boats-rise-and-fall-on-the-same-tides, (we're in this together), or eat-what-you-kill (we're a group of individuals or small teams sharing overhead and space).

- The system is skewed in favor of a few powerful owners who recognize it is not fair, but do not want it to change. This is particularly damaging when there is a generational difference, and the senior generation continues to take an unfair share of profits from the younger generation which creates them.

Let's acknowledge that there is no perfect compensation system. In fact, when a firm does well financially, even the worst compensation systems seem fair. By the same token, when profits drop, even the best of compensation systems can appear seriously flawed.

There are still a fair number of owners who were enticed to move laterally from one firm to another by guarantees of hefty bottom thresholds in compensation. I get that. Those deals were established in a much stronger economic climate. Risk seemed low and rewards were high.

For large firms, guaranteed compensation can run as much as a million or more. For a mid-size firm, the $500K+ obligation can be just as damaging when profits drop. So what happens to the other owners, who have no guaranteed minimum compensation, when profits are down? Either 1) they take a hefty reduction, which causes great rancor, 2) they try to change the deal which could have ugly private and public consequences or 3) they try to make up the difference by gaming the numbers or borrowing. You've no doubt read, heard about, and perhaps witnessed all three.

Another indicator that a compensation system is no longer working properly is the departure of one or more practice groups or, for smaller firms, individuals in certain practice areas. Firms which keep trying to "rebuild" one or more practice areas, and just can't seem to make it happen, should consider that the problem may not be a result of poor hires or acquisitions.

Admittedly, most firms are surprisingly bad at hiring the "right" people. [For a copy of my resource on hiring attorneys, which includes several helpful articles and other items, send an email request to lawpractice@pabar.org.] Just because your firm might not hire well, that doesn't exclude the likely possibility that a malfunctioning compensation system might exacerbate the problem, or actually be the cause of it.

For example, family law attorneys have a difficult time operating in many multi-practice area firms. They work on tight margins. Their billing cycle is different. Their fee payment is often greatly delayed. It's difficult to charge clients for all the small increments of time, even if recorded.

When the firm's overall overhead runs high, it can adversely affect the earnings of the family law attorney, whose actual practice area overhead is much lower. Firms struggle to hold onto these attorneys, for the perceived benefit to their other clients. Yet they usually make no efforts to really analyze whether they are properly allocating overhead when measuring profit and determining compensation of the family law attorney.

Add to that a lack of associate support from the firm — given a choice associates want to go into the more exciting areas, higher profit areas, or higher activity areas where they are guaranteed a healthy variety of work assignments — which often precludes the family law attorney from achieving greater leverage and improved profit margin.

Add to that a decided lack of cross-marketing, mostly because most compensation systems actually discourage it. So for certain practice areas, like that of family law, individual attorney marketing efforts must be greater to be successful. More non-billable time, less quality of life.

Off the top of my head I can think of several other practice areas which suffer the same adverse effects from faulty compensation systems. Just think about those attorneys you frequently see joining firms, only to wind up back in solo practice, or in a practice-area boutique.

Certainly, there will always be practice areas which can create conflicts of interest with other practice areas, and are best kept in separate firms. There will always be tension and a few occasional barbs flung between the contingent group and the hourly group. We expect that. But we acknowledge that for the most consistent cash flow, and the greatest ability to be of service to clients, most firms are better off with a variety —albeit limited number— of practice areas co-existing.

If you're having trouble holding onto your "next" generation, if you're having trouble holding onto certain practice areas, if owner discontent is high, if compensation is deemed unfair, if your firm is borrowing to meet owner compensation expectations, it's time to take a close look at your compensation system. And probably to seek help.

One last very important point to make. No change in a compensation system makes up for a shortfall of revenue or profit. Changing the way you slice and serve the pie does not make the pie larger. That's the topic of a whole other article. What it can and ***should*** do is properly reward what the firm expects from and values in owners, and create accountability for owners who fail to deliver.

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