Reaping Rewards

Establishing Standards for Law Firm Bonus Programs

BY ED POLL

Compensation is a common area of focus in law firms of all sizes. For partners, it's a matter of how year-end financial results affect their direct payouts in a small firm, or the decisions of the compensation committee in a large firm. For associates, and as well for bonus-eligible staff, the focus is somewhat different, and often centers on one question: "How big will my bonus be?" And that can create definite problems. The real question should be, "Do I deserve to get a bonus?" If that question isn't being asked, the firm's leadership should evaluate how it approaches the whole concept of bonuses.

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WHAT IS A BONUS?

A bonus is, or should be, additional compensation to reward a level of performance that goes beyond mere satisfaction, but the nature and degree of "exceeding" can be hard to define. For starters, associates may have their expectations set too low about how they have outperformed the standard, particularly when the firm did not explain clearly what kind of performance is expected as a baseline. In this sense, lack of a clear definition for "exceeding expectations" represents a communications failure.

From the associate's standpoint, actually exceeding expectations when the standards are fluid creates a different dilemma. Human nature being what it is, partners will expect even greater exertion and achievement next time. At some point, it becomes impossible to continually exceed what the firm seems to want; the best the associate can do is meet expectations. And by any reasonable definition, merely meeting expectations does not merit a bonus.

CONTROLLING EXPECTATIONS

In firms that give associate bonuses, people tend to expect what was. The problem with that, from a legal perspective, is that it virtually becomes part of their compensation. And if any members of your firm think they are not receiving parts of the "salaries" they believe they are entitled to, a lawsuit or discrimination claim could result. It's important for the firm to short-circuit such an entitlement mentality by making it clear that a bonus is not an automatic part of associate compensation.

That can be problematic for those firms that don't believe in sharing financial information with associates. Their operative mentality seems to be, "We're paying associates enough as it is, and if they know how much we're actually bringing in, they're going to want even more." Associates do tend to focus only on the big picture – revenue – and forget to take into account bottom-line items like collections and

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overhead expense. More importantly, they tend to forget that they are part of the overhead, and that every new associate increases overhead expense.

THE PERSONAL P&L

Ultimately, sharing financial information with associates benefits the firm as a whole because it gives associates the means to understand their own personal profit and loss calculations, thereby better determining and understanding their worth to the firm. The information to share (which doesn't begin to encompass the cost of the time that the firm spent recruiting and training the associate) would include:

- their billable hours, for the latest month and year to date;
- how many hours the firm billed out for them, versus a markdown or write-off for some of the work (individually or as an average percentage applied to all associates);
- direct expenses for compensation (including bonus and benefits), clerical help, technology, office space, etc., related to the associate; and
- indirect expenses, or overhead (the percentage of rent, insurance, utilities, entertainment, and education that each associate accounts for).

The result should determine an individual net profit value to the firm:

Billings - [Associate's Total Compensation + Direct and Indirect Expenses] = Net Profit.

Creating a bottom-line figure like this can help resolve a not-uncommon dilemma. Say the firm has always given decent year-end bonuses to associates, but in the current year accounts receivable are uncomfortably high. Meanwhile, expenses (including associate salaries) are higher. If receivables are not received, the firm cannot afford to pay the bonuses that associates are accustomed to. Basing such an action on the bottom-line figures of the profit and loss sheet and making sure associates understand the reason for it can go a long way toward heading off hurt feelings and outright discontent.

STAFF BONUSES AND JOB STANDARDS

The payment of bonuses becomes an even trickier issue when they are awarded to a firm's staff members. This can be anything from a significant payment to an annual "holiday bonus." If a lawyer takes the initiative to win a new client or begin a new practice area, the "bonus" comes from the increased revenue and profitability generated by the lawyer's efforts. Staff members, by contrast, rarely have any direct influence on the outcome of firm revenue and expenses. If someone has no control over a particular activity yet receives a bonus because the organization overall is doing well, it typically results in one of three responses:

- The bonus doesn't register, because the staff person cannot relate personal effort to it.
- The bonus creates a feeling of entitlement, because the staff person has nothing at risk.
- The lack of a bonus, if firm performance slips, creates disappointment and cynicism, because the staff member could not control the outcome. This is especially true if the perception exists that the partners' income is not reduced in amounts corresponding to the decrease in the firm performance.

Having a comprehensive job description for every staff position in the law office is a prerequisite to an objective and efficient bonus program. The absence of such descriptions promotes inconsistency and threatens objectivity. Descriptions should include the specific, significant tasks of each position and the performance standards by which the accomplishment of these tasks is judged. When employees understand what they should be doing and how they are evaluated, their performance is more likely to be positive – and they are less likely to question the fairness or appropriateness of any bonus payments.

THE BEST APPROACH

Experience shows that the best approach to law firm staff bonuses is the creation of a pool that reflects the firm's year-end financial statement. One approach is to identify the net profit after all expenses and all attorneys are paid, and then assign staff members a fixed or variable percentage of that pool. Another approach is to pay bonuses based on revenue and assigning bonuses based on a revenue pool – which has the advantage that most people understand the concept of revenue and believe it cannot be "manipulated" as can profit.

Of course, the firm could prefer not to be tied down to a specific formula, instead saying that because performance this year exceeded a three-year average, individual staff efforts are being rewarded by cash payments of varying amounts. The key to success here is to have accepted standards in place to judge "performance."

'SKIN IN THE GAME'

Clients increasingly reward lawyers for having "skin in the game" – a personal financial stake in the outcome of a matter as reflected in fees that go up when the results justify it. Law firms should take the same approach to the payment of bonuses, making it clear that the payment reflects over-and-above effort and not just the time of year on the calendar. Being clear on the standards for and nature of bonus rewards is fundamental to making bonuses a meaningful compensation tool.

about the author

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