STRUCTURING COMPENSATION FOR A COMPETITIVE MARKETPLACE

By Ed Poll

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During the past four years there has been more change and controversy regarding lawyer compensation than in the several decades before. Consider these key signposts on what has been a very bumpy and uncertain road:

- As the economy began its slide into recession, starting associate salaries of $160,000 and partners with $1,000 an hour billing rates were the talk of the law profession.
- Within two years, starting associate salaries at the largest firms were cut by 25 to 50 percent, and those associates still being hired were assigned to pro bono or internal internships.
- At the same time, senior partners viewed as not pulling their weight (that is, not bringing in enough billings to justify their high compensation) were de-equitized out of their firms.
- Offshoring of routine legal work to India and other countries, with a resulting cost savings of up to 80 percent over domestic lawyer rates, quickly became accepted…
- … only to be followed today by "onshoring" of the same work back to the U.S., to contract lawyers paid $50,000 and located in low-cost states like West Virginia and North Dakota.
- New virtual organizations like Axiom pay discounted rates to a freelance group of lawyers who used to work at major firms, but now work at home or at client locations.

Such developments reinforce the fact that law firms no longer can or will pay compensation out of scale with what clients will accept. There is a direct interrelationship between law firm billings, profits, and partner compensation. That interrelationship is expressed in various ratios and weightings, with wild cards like origination credits tossed in for good measure. But the essential fact is that the value clients want increasingly determines what lawyers will be paid. As embodied especially in the Association of Corporate Counsel (ACC) Value Challenge, that means more efficiency in fees, and less emphasis on increased profits per partner. The objective is lower costs, and law firms will increasingly feel the brunt of that effort.

Traditional Compensation Approaches

In such an environment, an understanding of how law firms arrive at lawyer compensation is essential. Typically there are considered to be two general compensation models: lockstep, in which the firm's overall success each year is averaged out to determine a standard rate of compensation increase for most lawyers, and "eat what you kill (EWYK)," in which all attorneys are rewarded on how much business they personally bring in. Each has advantages and disadvantages:

- Lockstep is good at building collaboration, client service teams, and institutionalizing clients.
- Lockstep is bad at rewarding exceptional performers and penalizing subpar performers.
- EWYK is good at developing new business and new markets, and spurring entrepreneurship.
- EWYK is bad at cross-selling services and promoting firm harmony.

Any firm that encourages lawyers to maximize their individual compensation may have

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fast near-term growth. Approaching compensation as an institution makes for greater firm harmony and longevity. Either way, however, both lockstep and EWYK systems generally depend upon the same metrics: hours worked per year, origination credit, supervision credit, and other formulaic measures based on the billable hour. How many hours are billed *and collected* is the essential issue. The level of collections determines firm profitability, and profitability determines how much is available for compensation. The firm can either assess revenue to figure out what the cost structure should be so that the firm can turn a profit, or it can look at costs and determine how much revenue is needed to cover the costs and make a profit. These two models define what's available for the total compensation pool.

Law firms mirror their clients. To the extent that law firms provide the service their clients need, at the price clients are willing to pay, they will have an adequate compensation pool. Otherwise, they will be challenged to stay in business. As corporate clients seek to reduce their legal expenses by paring down outside counsel firms dramatically, the survivors are expected to provide certain work with relatively steady volume (such as patent filings or employment cases) at fixed rates over a certain period of time, turning these matters into the legal equivalent of a commodity. Commoditization is also increasingly becoming an issue for solos and small firms. The Internet has a growing list of legal services used by individuals (such as wills, bankruptcy filings, even divorces) being offered by law firms at low fixed prices.

Revenues Up, or Costs Down?

That brings us back to our two models for funding compensation: increasing revenues to cover costs, or reducing costs to match revenues. Begin with the revenue side. In a law firm, revenue is a highly personalized commodity because it is the product of each person's individual effort. The measure of that effort is billing rates and related fees, so increasing revenue puts the focus on whether to raise rates. Of course, in today's legal services environment, raising rates is generally a non-starter. Rates charged must be determined in the context of all the labor being devoted to client service, including paralegal and staff time as well as lawyer time. It is also possible to increase revenue by winning new business, but the chicken-or-egg issue here is whether the firm can do this if its rates are not low enough to be competitive.

LAW FIRMS NO LONGER CAN OR WILL PAY COMPENSATION OUT OF SCALE WITH WHAT CLIENTS WILL ACCEPT

The concerns on the cost side are no easier. Consider a law firm where the revenues from a given client are 10% less than the costs to service that client in lawyer and staff compensation. In this critical situation a decision must be made to reduce costs. The choices are hard, but each one must be considered in turn:

- Terminate the client relationship and the revenue it represents because the client cannot be adequately serviced within the firm's cost structure.
- Invest in technology for more efficient service, which may eventually reduce costs but in the near term raises costs due to the expense of equipment, software, and training.
- Assign fewer people to handle the client workload, which may decrease costs but also can decrease service to the point that the client is dissatisfied and pulls the business.
- Reduce staffing and leverage ratios so that lower-compensated associates and paralegals handle tasks formerly carried out by higher compensated senior partners.

It is apparent that there is no easy way to adjust costs to revenue. Certainly it can be done, but the strategies for doing it each have drawbacks that are hard to overcome.

The Team Solution

Given these complexities, the best compensation approach in today's cost-sensitive environment is a variation on the lockstep concept: using the client team philosophy to both increase revenues and reduce costs. Base compensation in this approach is tied to the effectiveness of involving other firm lawyers as part of the team delivering legal services to clients. This allows for blended high and low rates on client work, maximizing revenue and profitability. Compensation is paid based on what is generated for the organization—not for any one individual—because the organization's revenue is maximized, and so too are profits, which are the lifeblood of organizational survival.

TO THE EXTENT THAT LAW FIRMS PROVIDE THE SERVICE THEIR CLIENTS NEED, AT THE PRICE CLIENTS ARE WILLING TO PAY, THEY WILL HAVE AN ADEQUATE COMPENSATION POOL

One can use a sports metaphor, comparing athletic teams that have one or two self-centered, freelancing stars to those teams with no stars, but great cooperative skills. While it is possible for the former to have a good season (often followed by a collapse), it is the latter model that is the more satisfying and longer lasting. The team model provides the greater satisfaction because the collective nature of the achievement allows everyone to stay at the top longer. The best law firm compensation approach gets away from a star system that rewards only the individuals who are out for themselves by also rewarding those individuals who help the team perform better. This creates a more profitable firm, from which all firm members benefit. In today's competitive legal marketplace, it enables billing, profits and compensation all to reinforce each other.

The team approach makes explicit the tie between individual compensation and the firm's overall revenue. Firms that service major clients with teams (not just a single rainmaker) can identify and provide needed practice specialties that reflect a full range of client concerns. A billing attorney coordinates the service provision according to a strategic plan, and can give clients a complete and virtually seamless service package. The client receives "one-stop shopping" from a group of lawyers who are chosen to address specific needs, both in terms of practice specialties as well as billing rates.

Teams represent a cooperative effort to increase revenue within a compensation model that depends on the success of the organization. Compensation is paid based on what is generated *for the organization*—not for any one individua—because the *organization's* revenue is maximized, and so too are profits, the lifeblood of organizational survival. In "The Business of Law®," as in the business of life, a rising tide does indeed lift all boats.

Ed Poll *is a speaker, author and board-approved coach to the legal profession. LawBiz® and Fujitsu are sponsoring Ed's cross-country tour to reach bar associations and law schools. If you want Ed to stop in your community, contact Ed directly. Readers with questions for Ed should email edpoll@lawbiz.com or call (800) 837-5880. You can also visit his interactive community for lawyers at www.LawBizForum.com.*