

Partner and Shareholder Compensation

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Overview

The form of organization a law firm selected has a significant impact on the tax consequences of its compensation program. It is largely irrelevant, however, in connection with the principles used to determine compensation within a law firm. For the purpose of this discussion, *salary* and *draw* will be interchangeable terms, as will *bonus* and *distribution*. Documentation differences are important because of the need to ensure the desired tax consequence of these transactions. Differences in compensation methodology between partnerships and professional corporations therefore are primarily driven by the tax treatments the firms and their owners desire to receive.

Devising a compensation program for the owners is, by far, the most difficult compensation-related task. Owners must deal from “inside the circle” on this issue. Associates, of counsel, and staff are all external groups and generally do not have the same level of risk-associated attributes in their compensation as do owners.

Owner compensation generally comprises three elements. First is remuneration for the fair value of an individual’s contributions in the provision of legal services and for other services to the firm. Second is a return on invested capital—although those firms which pay interest on capital handle this element separately. Third is allocation of profits among the owners. These three elements are peculiar to a closely held business, where the owners are active in the day-to-day affairs of the business. Many compensation

programs try to address all three elements from an undivided pool of money. In a manufacturing setting, there is much guidance concerning the relationship among the value for services rendered, the return on invested capital, and the allocation of profits. In a law firm, such guidance is largely unavailable.

Partner and Shareholder Compensation Criteria

The following unranked attributes regarding the compensation criteria for law firm owners should assist readers in evaluating their experiences. If your firm's experience is not consistent with the generalities and the program is working, then do nothing. If the program is not working, then look for differences and see if they offer some direction.

Ownership

Partners or shareholders, as owners of an enterprise, share in the profits and losses of the business, which, along with a return on their capital, reflect their investment risk. The owners of a law firm are, after all, entrepreneurs. They meet payroll, accept liability for the firm's activities, and provide capital. The most important asset of a law firm, however, is its client base, and clients cannot be owned or sold. The courts have consistently upheld the client's ultimate right to choose legal representation as a matter of public interest and policy.

However, it is possible for a practice to be transferred for consideration. Internationally, the public offering of ownership interests in a law firm has occurred in Australia and in the United Kingdom. In the United States, the American Bar Association and most state bars have set forth guidelines involving such transactions that go beyond the scope of this text. However, at this writing, there is a very practical limit to the transferability and, thus, the value of ownership in a U.S. law firm.

Some law firms pay interest on capital invested in the firm as a way to reward ownership or to provide a market return on equity. In professional corporations, owner capital can be structured as a combination of equity and debt such that a return (interest) is paid on the debt. Although dividends can be declared and paid on equity, it is not tax efficient to do so. This is probably the easiest and best method to handle a return on invested capital. It removes return on capital from the compensation decision, allowing the owners to compensate for an individual's contribution to the provision of legal services and engagement in firm management activities and to allocate among the owners the profits generated by others.

Law firms have generally separated compensation from ownership. That is, relative compensation levels do not affect or track relative levels of ownership. This should always be true for those lawyers practicing in professional corporations, to avoid treatment of compensation as dividends, subjecting all or part of

it to double taxation. Partnerships have also determined that compensation and ownership can evolve on separate tracks. However, the topic of allocating ownership interests can be as significant an issue as compensation. Ownership is now viewed as a means to apportion the owner capital needs of the organization and to establish certain voting rights in the governance of the firm's affairs. The level of importance accorded ownership in compensation has decreased.

Seniority

Although some firms structure their compensation program entirely around length of service in the profession and in the firm, the seniority factor at other firms carries little importance in compensation decisions. This came about primarily because of the increasingly competitive nature of the profession.

However, a key aspect of the strength of an organization is its longevity and stability. Within law firms that seek to preserve or acquire these characteristics, tenure is accorded some significance. These characteristics often are important, not only to clients who quickly tire of following their lawyers from firm to firm, but also to lenders and landlords who recognize the importance of those traits in securing the repayment of long-term obligations. Insurance underwriters are also aware of the importance of career association with a single firm in the prevention of errors and omissions.

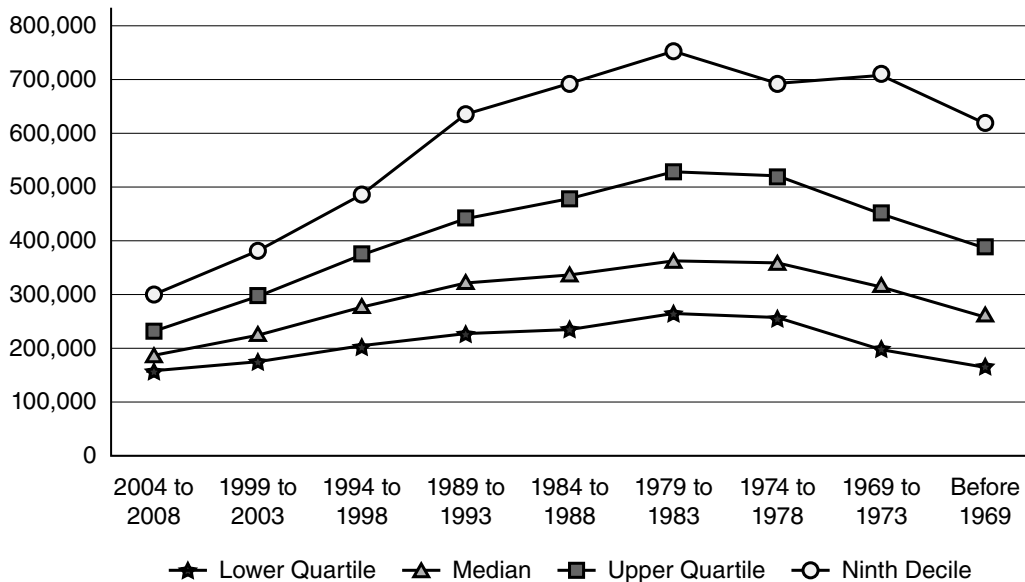
Respondents in the ALM Incisive Legal Intelligence compensation systems study¹ indicated that seniority within the firm was the least-considered factor in owner compensation, while years of experience as a practicing lawyer had some importance in the compensation decisions. There is a strong correlation between years of experience and compensation, driven in part by economics (higher billing rates and greater efficiency of experienced fee producers) and by traditional notions of progressive compensation over a career. Illustration 1.1 depicts the general trend of compensation throughout a partner's career. Generally, a partner's earnings peak around the thirtieth year of practice.

Seniority encompasses more than just a person's age or the number of years he or she has spent at a firm. One New England partnership broadly defined seniority to include the "number of years the partner has spent developing and maintaining clients, building and enhancing the firm's reputation, and participating in the training and development of a cadre of lawyers who produce for the benefit of all the partners in the firm."

Pro Bono

Pro bono and other activities where lawyers are involved in service to their communities generally are of little importance in compensation decisions. Pro bono serves as an opportunity to learn and develop as an adviser, while simultaneously giving back to one's profession and community. Provided the efforts are balanced against other contributions and the firm coordinates the activities, they should be considered when compensation is determined.

ILLUSTRATION 1.1
MEDIAN TOTAL COMPENSATION BY YEAR ADMITTED



Source: 2014 Survey of Law Firm Economics, ALM Legal Intelligence.

Teaching, Writing, and Speaking

Another way lawyers give back to their profession is to assist in the educational process of other lawyers. Some lawyers may teach continuing legal education classes or lecture at law schools, or they may write for legal journals or speak at bar association meetings. Aside from the obvious benefit of enhancing the knowledge level of the profession, such activities allow individuals to establish credentials as experts in selected areas of the law. Some firms choose to reward educational endeavors.

Collegiality and Team Play

Collegiality is adherence to the spirit, as well as to the letter, of firm policies, a willingness to pitch in when needed, the sense of working and getting along together in a spirit of cooperation, a mutual respect for others' skills, and tolerance for others' weaknesses. It is important to those firms seeking to foster a team orientation. Practicing law is a stressful profession. A lawyer does not need to work in the company of individuals who view themselves as more important than the firm. Contributions toward internal harmony—a sense that the firm will pull together to meet the challenges and demands facing it—have gained importance in compensation decisions.

Training

Law firms engage in an ongoing process of inducting new members (lawyers, paralegals, and staff) into the organization and integrating them into the work system. In team-oriented firms, such integration is essential and valued accordingly. Law firms make substantial investments in finding and paying new lawyers and staff. The quality of supervision, training, and monitoring inexperienced individuals receive is of significant importance to their development and to the quality of service provided to clients. For these reasons, law firms should pay those who are skilled trainers and commit time to these activities.

Expertise

Expertise in a specialty or in some facet of professional activity is largely considered a necessity in modern law practice. Some experts are at such a high level (the precedent setters), or operate in such an esoteric area of commerce or the law, that they have value for certain law firms independent of their economic contributions.

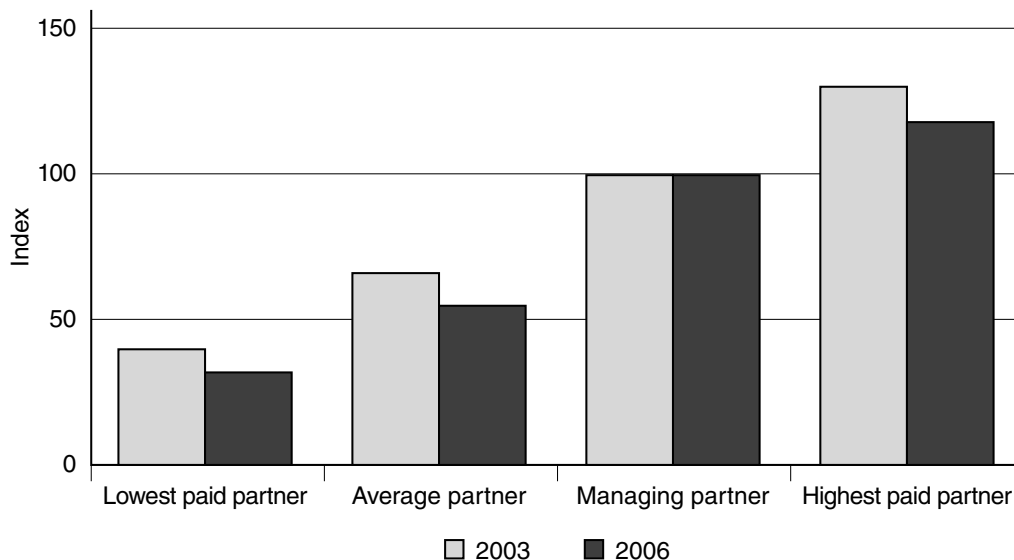
Legal expertise is most broadly defined as the quality and efficiency of work product and advice, particularly if the expertise is outstanding and the lawyer serves as a resource for others within the firm and legal community. Someone once said he could not define quality but could identify unacceptable work product, service, or advice. The following definition, used by a client of Altman Weil, conveys the concept of quality well: "Quality includes knowledge of applicable law, imagination, creativity, and innovation; the ability to write clearly and persuasively; the ability to analyze quickly and accurately; the ability to exercise good judgment; the ability to plan and implement legal strategies; good oral communication skills; the ability to handle the unexpected; the ability to negotiate; and the ability to handle complex matters."

Leadership and Management

In industrial and business settings, management is paid more highly than production, and sometimes more highly than sales. However, many law firms do not pay for management at all. Illustration 1.2 shows the relative earnings of the highest-paid partner, average partner, lowest-paid partner, and managing partner. Generally, if a law firm does not pay for management it will have little, if any, management because uncompensated work is given grudgingly. Firm-approved budgets, combined with documented duties and authority, provide a framework for compensation considerations. As shown in Illustration 1.2, over the two studies, managing partner compensation has improved relative to their counterparts.

Firm management (defined as contribution to firm, office, or practice management, including services such as acting as the firm's managing partner, chairing a department or practice area, leading an office, or serving on committees such as management, compensation, and recruiting) is a necessary and important

ILLUSTRATION 1.2
RELATIVE AVERAGE COMPENSATION



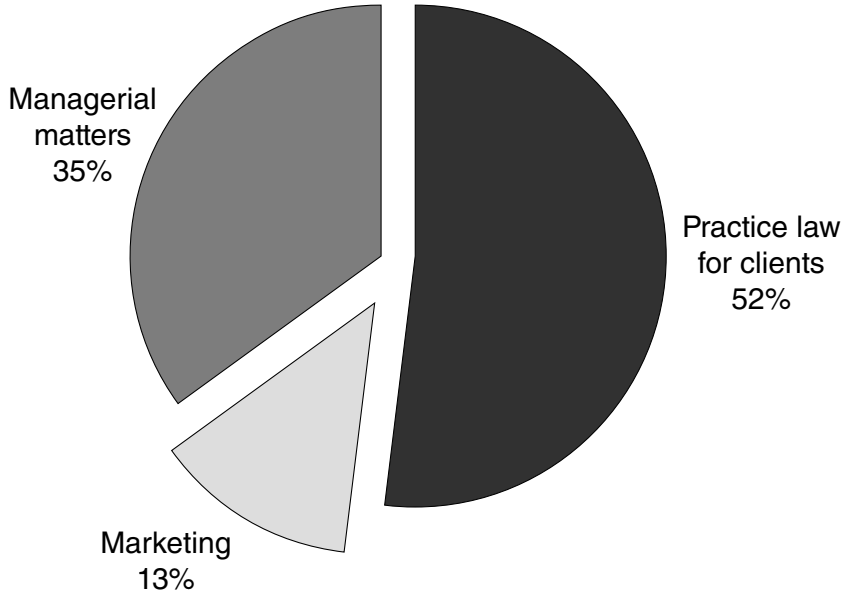
Source: 2004 *Law Firm Managing Partner and Executive Director Survey* and 2007 *Senior Leadership Survey*. For Law Firms, Altman Weil Publications, Inc., Newtown Square, PA.

function in any modern law firm. Good management requires time and effort—the same time and effort one would otherwise devote to fee-paying clients. A firm’s recognition of the importance of management and the sacrifices good managers make is crucial. Illustrations 1.3 and 1.3.1 depict how the typical managing partner’s time is allocated.

As firms grow, management becomes more centralized and the manager’s role more important. Centralizing management is necessary to carry out the firm’s functions in an effective and efficient manner. Centralizing management responsibilities in one person or a few people requires reducing the contributions of such persons elsewhere, which is true especially for managing partners.

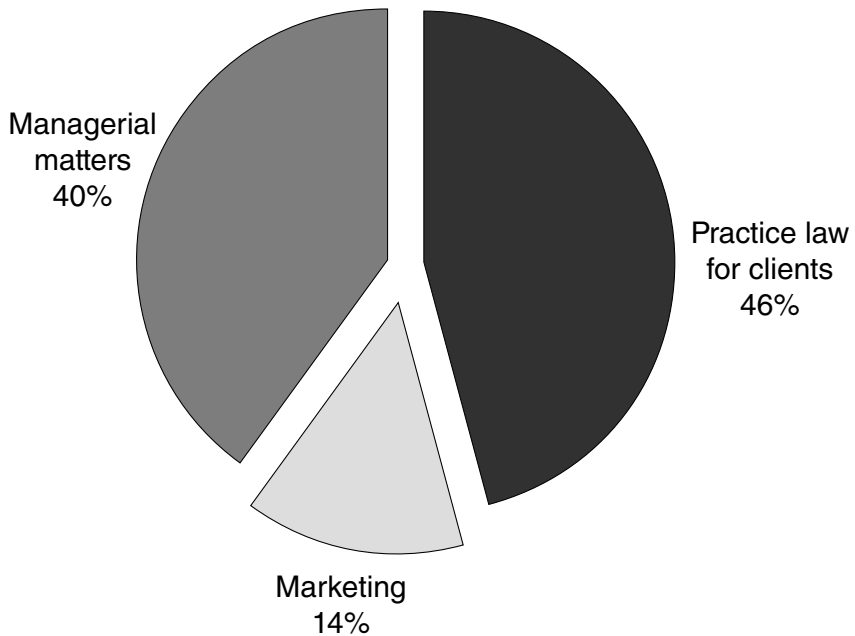
Compensation issues arise not only in valuing the management contributions of a sitting managing partner but also in determining compensation during the transition from management back into practice or some other role. This may not have been an issue when managing partners left that post for retirement, but typically managing partners are now younger and their practices are quite active. To take on a substantial leadership role, he or she will often transition practice and client responsibilities to other partners. When it comes time to turn over the reins of authority, instead of imminent retirement, the former manager is now only 60 years old (or younger) and may not look fondly on rebuilding a practice. Firms must consider this typical scenario and provide a rational program to properly transition the former leader into his or her new role and to provide for

ILLUSTRATION 1.3
HOW MANAGING PARTNERS SPENT THEIR TIME IN 2003



Source: 2004 *Law Firm Managing Partner and Executive Director Survey*, Altman Weil Publications, Inc., Newtown Square, PA.

ILLUSTRATION 1.3.1
HOW MANAGING PARTNERS SPENT THEIR TIME IN 2006



Source: 2007 *Senior Leadership Survey For Law Firms*, Altman Weil Publications, Inc., Newtown Square, PA.

appropriate compensation during that transition period. Failure to consider this situation makes it harder to get senior management to step down from that role when appropriate, and it sends the best of the next generation running for cover.

Fees Collected

Fees collected are an economic necessity. In professional services, maintaining a complement of fully utilized and properly priced timekeepers, whose time value is quickly and nearly fully collected, is essential. Fees collected as a working timekeeper are the single most determinative factor in a timekeeper's compensation over his or her career, slipping behind origination once a lawyer becomes a partner.

Law firms measure fee collections through objective criteria such as working lawyer, billing lawyer, originating lawyer, and responsible lawyer. While such data are also available denominated in hours, time value worked, or billings, the author prefers to measure at the end of the transaction cycle—cash collected, which is what pays the bills.

Client Retention

Client retention is defined as including both client responsibility (a lawyer's maintenance of good client relations and service, even if little work is actually performed by that lawyer) and case responsibility (delegation and direction of others' efforts, to obtain the best possible results for the client). Responsibility for maintaining the existing client and growing that client's business is acknowledged as an important element for survival in a competitive market. Many law firms reward the billing partner or responsible partner for this client-retention function based on fee collections from work done by others. Such reward is often separate from the traditional origination or sales function.

Origination and Sales

Clients are the single most important determinant of a law firm's viability. The rainmakers—the people who establish and cultivate client relationships—are the lifeblood of a professional services firm. The ability to develop and maintain client relationships that serve as a conduit for work coming into the firm is the skill that establishes authority, power, and independence within a law firm. Those lawyers are the net exporters of work to others in the firm. There may be no more important decision for law firms today than judging this skill and doing so accurately for promotion and compensation decisions. It has been, and continues to be, the dominant compensation driver for partners.² The other productivity criterion that drives compensation is personal productivity measured as fees collected as a working lawyer (see earlier mention).

Formal origination credit scoring is now used in just under two-thirds of law firms overall. This is an increase from around 50 percent a few years ago. However, formal credit scoring is far more likely in large law firms. This should not be surprising, as small-firm partners are more likely to have an intuitive grasp of where

and how business is generated than do the compensation committees of large law firms. When formal credit systems are used, many will ask for how long a partner should expect to retain the credit. Much has been written about the need to “sunset” origination—that is, individual attribution becomes firm attribution after some period of time. The argument in favor of this position posits that after a period of years, many lawyers within the firm service most clients, and the reason that a client continues with the firm is due to collective, not individual, effort. In such firms, the origination credit may reduce much the way an insurance sales commission reduces to a very small annuity. In others, the credit vanishes or is awarded to a department, office, or the firm. Sometimes a responsibility or maintenance credit is awarded to those responsible for maintaining a current relationship. Many a firm has wrestled with the partner who retired on origination annuities, which is sometimes exacerbated when the partner can’t remember the names of the clients! However, the data suggest that firms have overwhelmingly adopted the view that origination runs with the client as long as the client is with the firm.³

The view that origination runs with the client probably is more consistent with the marketplace perspective that origination belongs to those who hold the relationships that bind the client. This view can foster destructive behavior if taken to an extreme. Management must instead encourage a culture and recognize behaviors that create broader and more in-depth relationships between firms and their clients to mitigate that behavior.

Participation in Community and Bar Activities

Lawyers are visible members of their communities. Recognition is achieved through press reports on lawyers’ courtroom skills and engagements in the political arena. Visibility is also achieved through lawyers’ contributions to civic, volunteer, charitable, community, and religious organizations and similar activities. Such efforts certainly enhance the community; they also elevate the image of the lawyers’ firms, while simultaneously polishing the subtle yet important leadership, advocacy, analysis, and problem-solving skills of the lawyers.

In law firms that foster strong feelings of obligation to the law as a profession, credit may be given for participation in local, state, or national bar association work or other community activities.

Many law firms recognize the importance of these activities, through support of individual participation and through compensation. Relationships established through these other avenues often are the means to business opportunities. Some firms with specialty practices, which rely heavily on referral work from lawyers, attribute much of the referral work to the friendships that develop as a result of bar association work.

Some law firms look favorably on exemplary contribution in these areas and recognize it in their pay plans, some regard it as an obligation meriting no special credit, and a few actually penalize excessive contribution, although they would not be likely to say so.