Managing Compensation Challenges in a Pandemic Year

Now that summer has ended and workloads appear to be stabilizing, partners are beginning to ask, "how will the firm treat me in compensation this year?" Regardless of whether a firm has had a bad or a great year, 2020 promises to be one of the more challenging times to set partner compensation.

In 2018 we wrote an article for **The American Lawyer** called "**Managing Compensation Expectations in a Record Year**," in response to the extraordinary hours and profits firms were generating. As most leaders know or quickly discover, managing expectations is one critical key to successfully setting compensation. It is important in the good times when expectations can easily get out of control, but even more critical during bad or unsettled times when firms face more difficult decisions. While the techniques outlined in our 2018 article still apply, there are new issues arising this year that are prompted by the widely disparate workloads and profits in the pandemic economy.

Emerging Compensation Issues

We counsel and serve on partner compensation committees for law firms across North America and abroad and are getting more, and more unusual, questions about compensation than is typical for this time of year. The following are just a few examples of the issues partners are raising with their firms right now:

- "Obviously, we will hold partners harmless from the effects of the recession since it wasn't their fault the economy shut down…right? Right?"
- "We have overpaid some partners year-after-year, increasing their compensation only because the firm did well even though the partner's performance has been declining for years. And we rationalized that by saying 'we should not be greedy when there is plenty of money to go

around.' If profits are tight this year isn't this the time to hold those same partners accountable for their long term, lackluster performance?"

- "My practice had record hours throughout the pandemic. Our group carried the firm. That contribution has to be reflected in compensation this year."

- "Our profits are (up, down) X% for the year. Why don't we just chalk this up as an anomaly year, give everyone an adjustment for X%, and we will go back to our regular process and criteria next year?"

It is not surprising that this unusual year is raising unusual issues. Most people prefer normality and predictability, but they are also quick to wonder if the old rules don't apply in a crisis. How are successful firms managing compensation expectations in a year like no other?

Since most firms operate on a calendar year basis there isn't much time left to prepare partners. But there are steps firms can take now to make the process less stressful, to ensure partners are satisfied with the results, and avoid confusion in the process.

One of the most effective steps firms can take is to get their compensation committee together early so they can agree on compensation philosophies and approach in advance. By developing consistent answers to common questions that are likely to arise they can avoid conflicting messages. Even in a normal year partners will ask compensation committee members "what are we going to do about compensation this year?" A casual, offhand comment can quickly become the rumored radical new policy of the committee and the firm. Even worse, contradictory statements from compensation committee members prompt accusations that the firm doesn't know what it is doing, or that there are different rules for different partners.

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Does Your Firm Have a Compensation Philosophy?

One of our common experiences as consultants is to interview members of a firm's compensation committee and ask each in private to explain the firm's system and core philosophies. In more than half of all firms those explanations are contradictory and the described compensation criteria vary according to whom you ask.

Firms with a clearly defined philosophy benefit from more consistent messaging, are better at managing partner expectations, and seem to suffer less partner turnover. And that last point may be the most critical this year: While overall lateral activity declines during a recession, the

decrease is offset by the fact that those who do move tend to be among the highest performing, most highly compensated, most significant rainmakers. One only has to look at recent headlines about significant lateral moves, as prominent partners or even whole practices decamp to other firms.

What is a Compensation Philosophy?

While there are as many compensation philosophies as there are systems and no one philosophy is right or wrong per se, it is helpful to note a few of the more common approaches that firms rely on:

- The most common partner compensation systems in North America are subjective base-and-bonus systems. Firms using these systems often have the philosophy that **base compensation reflects a partner's long-term (multi-year) value, while bonuses compensate for extraordinary performance in the current year only**. For many of these firms a single year's poor performance won't impact one's *relative* standing in base compensation but will reduce or more likely eliminate one's potential for receiving a bonus. Clarifying and reconfirming such a philosophy in a year such as this can alleviate significant partner anxiety about compensation.
- **Slow-up/slow-down** is one of the most widespread compensation philosophies embraced by firms. And equally widespread are the definitions of "slow." While relative steps up or down of 3% to 5% were commonplace 30 years ago, minimum steps have increasingly evolved to a range of 7% to 12% for the average partner move, and 20% to 30% for extraordinary performance. The challenge is that many partners want slow-up/slow-down to actually mean fast-up/no-down. Firms only worsen their challenges if leadership has avoided talking about compensation and performance or has implemented its slow-up/slow-down policy inconsistently in the past.
- There are still a few firms that have a philosophy of **never reducing the relative compensation of a partner,** but such firms are exceedingly rare. The few firms that use this philosophy successfully tend to have smaller partnerships, have extraordinarily high standards to become and then remain a partner, see only minor variations in the efforts and contributions of partners, and tend to have high profits. In a potentially down year the success of such a philosophy is dependent on these criteria still being true and readily apparent to most partners.
- The reality for most healthy firms over the last fifteen years is that it is now commonplace to **reduce the actual or relative compensation of 20% or more of the partner population every year**, even in years with record profits. It is important to clarify that such firms don't have a predefined number of partners to go down, but

rather it is just a reality that partners have widely varying contributions, and some partners will deserve to go down while others will deserve to go up.

- Many firms have general **guideline limitations on the maximum downward movement of individual partners in a single year**, such that most partners can't suffer a real decline of more than 25% in one year. The challenge is that some firms have become so accustomed to a seller's market and perpetually increasing profits every year that a lack of communication has effectively set a precedent that partners never go down. Or if they do it is interpreted as a signal of termination. What is the logic behind a limit on downward drops? Experience shows a single year's reduction of more than 25% often forces traumatic lifestyle changes and radical restructuring of expenses for most partners. While most people could argue that partners earning high incomes shouldn't be spending every dollar they earn, the truth is that many partners live at or above their income levels. So, a 25% reduction hits partners particularly hard. And while a partner's failure to manage his/her own finances is never justification to avoid accountability (and strong partner accountability is one of the common characteristics of long-term, highly successful firms), leaders should be prepared for dramatic reactions. Most importantly, firms/leaders should have communicated the likelihood of such changes long in advance of the actual compensation announcement.
- True lockstep compensation systems are now rare, but many firms use some form of "modified lockstep," meaning they have implemented mechanisms to alter progression and better reflect contributions. We have restructured a number of systems to implement **freeze provisions** (whereby partners can be stopped in their progression for one or more years), introduce **Super Levels** (extraordinary levels of compensation above the standard progression, often described as "slippery levels" for which there is less of a presumed stay-point if performance drops off) and various **bonus systems**. While these changes are rapidly infiltrating most lockstep firms, they represent fundamental philosophical changes and firms are well advised to implement these only after significant socializing. Rushing to make such changes in a month or two typically backfires, resulting in the loss of high performing partners unaffected by the change.
- One of the more confusing compensation philosophies is the **spread between the highest and lowest paid partner**. We regularly hear law firm leaders explain why *their* spread is successful and correct, and then see other firms emulate that spread only to see it fail. Despite what is written in the press, or said by various leaders, **there is no ideal spread that applies to all firms**. We work with successful firms with spreads of as little as 4:1, and successful firms with spreads as much as 15:1 or 20:1. Admittedly, there are fewer highly successful examples of the latter and more of the former, but that has less to do with the spread and more to do with their underlying cultures. Both systems can work well in the right circumstances.

One key to understanding compensation spreads is in the standards for a firm's partners. For example, firms with

- A single tier partnership, and/or
- Varying standards for partner admissions, and/or
- Widely varying quality and performance contribution levels, and/or
- A broad mix of high, mid-market, and commodity practices, and/or
- A "First Touch" origination tracking system ("I was the first person to touch that client, therefore I get lifetime credit/compensation regardless of how hard I work or my current relationship with my clients),

tend to have wider compensation spreads. In contrast firms with tough standards for making partner, those with large volumes of complex work, or those that enjoy a high degree of consistency among partners for work ethic and quality, tend to have more narrow spreads. It is easy to assume the spread is a *cause* of success when it more often it just *correlates* with success.

> ***"Recessions expose vulnerabilities. History shows that recessions prompt more prominent rainmakers to consider a lateral move, and in-house counsel are more inclined to question and change their longstanding outside counsel."***

What Can You Do Now to Improve Compensation?

1. Assemble your compensation committee now to discuss the concepts and philosophies you will be using this year, especially if they are different in any way from prior years. Even if they aren't different it is helpful to ensure everyone on the committee understands them and explains them in the same way. It is critical to do this now so that your compensation committee can begin socializing the concepts that will guide compensation as soon as possible. If your firm has a history of fluctuating philosophies from year-to-year (most often because a firm has rotated compensation setting responsibility among partners like a family Thanksgiving Dinner), then it is time to define more permanent core philosophies that will ensure what is best for the firm for the long term.
2. If you have not used the practice of interviewing partners in advance of setting compensation this is the ideal year to start. Like so many management practices this is one that can easily be done superficially, thereby missing out on the real benefits. Here are a few critical tips to doing compensation interviews well:

- Don't "gang-interview" partners. Behavioral science and experience show that two members of a compensation committee interviewing each partner together tends to produce the best, most constructive results.
- Don't assume everyone can conduct a good compensation interview. Partners who can't listen, who are intimidated by rainmakers, who can't talk about anything but themselves or who avoid difficult conversations should all be prohibited from this critical role.
- Great compensation interviews talk a little about compensation, and a lot about how a partner can better use his/her unique skills and strengths in ways that benefit the firm and his/her career. The theme should be how the firm can help a partner, and less about rationalizing or calculating a number. If a partner has behavioral or performance issues those should always be discussed. If a partner isn't performing consistent with his/her compensation that conclusion should be discussed and addressed.
- Great compensation interviews should always be two-way conversations. Interviews in which partners just recite their extraordinary contributions over the last year are largely a waste of time, rarely change performance or behavior, and almost always fail to manage expectations.

3. If your firm has been thinking about making structural changes to its compensation system but has not yet announced them, proceed with extreme caution: Recessions expose vulnerabilities. History shows that recessions prompt more prominent rainmakers to make a lateral move, and in-house counsel are more inclined to question and change their longstanding choice of outside counsel. Surprising partners with last minute, unsocialized structural changes may prompt unanticipated reactions. While all firms should improve their system so that it is competitive with their market, the key is to announce such changes well in advance rather than while compensation decisions are being announced.

This may be one of the most challenging years ever for setting partner compensation, given that some partners are having record years while others have seen practices decimated (even within the same firm). Law firms may have performed better than expected during the pandemic but that doesn't mean everyone will be happy, or that other issues won't be revealed. Remember, partners don't abandon their firms over money alone: They leave because of a lack of confidence in firm leadership and/or firm viability, because they perceive their firm is mishandling compensation for underperformers, or because they want to go to a firm where more partners reflect their strategy, drive and client base. Law firms may have a reasonable financial year in 2020, but that doesn't mean they are less vulnerable to the compensation challenges created by the pandemic.

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Thinking about paying a Covid-19 Bonus to your associates? While bonuses rarely make associates unhappy, they have repeatedly been shown to have little impact on associate retention. Read our article, **Are Firms Fighting the Associate Salary War with the Wrong Weapon?** as published in ***The American Lawyer***.

Trying to energize and refocus your Board or Executive or Management Committee? Review our article, **Before You Plan Ahead Take a Hard Look Back**.

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