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Managing Compensation Expectations in a Record Year

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For many large firms 2018 promises to be the most profitable year since the Great Recession – barring any downturn in the 4th quarter. But as many leaders know, setting partner compensation in a great year is often tougher and can cause more internal dissension than in a bad year.

How can higher profits be a problem? It has to do with managing expectations. Hours are up, and it is now rare to find underutilized transactional lawyers in healthy firms. As busy partners hear profits are up 10% or 12%, expectations are raised, and partners who fall short of the firm's overall profit increase can easily feel cheated.

How do successful leaders/firms manage expectations? For most, it is a combination of:

- **Structural elements** in their compensation system, based on some surprisingly counterintuitive truths about human motivation and compensation,
- **Leadership techniques**, and
- Talented, communicative leaders.

Below are some of the most effective means for managing the compensation expectations of partners in good years and bad (note that there are a variety of partner compensation systems in use, so some solutions may sound foreign or won't apply to every system):

Structural Elements:

1. **Compensation Interviews**. Most firms understand the benefits of talking with partners about performance and compensation, but one important question is, is it better to do that before or after setting compensation? Firms sometimes surprise lawyers with a disappointing compensation decision, and then try to rationalize it after the fact. It has been repeatedly shown that post-compensation interviews rarely create satisfaction or understanding, much less change behaviors. Even among leaders who only do post-compensation discussions, it is common to find they dislike the process, they readily acknowledge it doesn't work well, and yet they do it repeatedly because it is all they know.
   It may sound illogical but talking to partners *before* setting their compensation produces dramatically better engagement, improved performance in the following year, and more effectively manages expectations. But they only work if firms do those interviews well, and unfortunately, perhaps only a quarter of all law firms meet that standard. Good interviews are two-way conversations, focused on helping the partner to be more successful. They explore each partner's strengths and weaknesses and include a focused discussion of priorities for the coming year. To do that well, those conducting the interviews need to be adept at both listening and coaching (if you are lucky, you may

find that 2% - 3% of your partners have those skills. That's not a criticism, just a realistic assessment of the rarity of the skills).
Where do these interviews go wrong? Some leaders conduct compensation interviews like a deposition, and not surprisingly, the partners walk out with all the satisfaction of a typical deponent. Just as bad, some leaders sit in silence and let every partner describe how extraordinary they are at everything they do. That fails the most basic test of managing expectations or determining how to extract the best possible use of that partner's unique skills and talents.

2. **Large Leaps, Not Small Steps**. Most firms have some defined structure in their compensation system, whether it be with points, levels or units. And that structure creates steps of compensation into which partners are slotted each year. If the differential between each step is too small, for example, 5% to 6% of compensation, it is much harder for the average partner to see clear differences between his/her performance and that of a partner paid one step higher. If the differences aren't clear partners then believe the system is arbitrary, or that leaders have made a mistake, and so they spend time arguing to everyone that they should be at a higher level. Firms that utilize larger steps of 10% to 15% between levels have a much easier time moving and grouping partners, and partners have a much easier time understanding the differences between groups at each level.

3. **Culture Failures**. Law firm cultures typically fall somewhere on a spectrum between partners competing with one another to increase their own relative compensation, or partners focused on increasing overall firm profits. (If you are in a firm more like the former, you may find it unbelievable that any firm could have a culture like that latter. That's just a testament to how radically law firm cultures vary.)
How does a firm create that latter culture? First, it takes communicative leadership that consistently mirrors the behaviors the firm wants to embrace, and that confronts and addresses those who foster an internally competitive environment. Most importantly, they do that consistently and with everyone – even big rainmakers. Because the moment they make exceptions for some, they lose their credibility as leaders. Changing culture has little to do with nice speeches about teamwork and collaboration – it takes talented, trusted leadership. Second, it takes time – time demonstrating that the firm is living and rewarding the values it claims, and then proving that over and over.

4. **Prospective vs. Retrospective**. *Prospective* compensation systems set all partners' relative compensation levels at the beginning of the year, and let those determinations control the distribution of profits through the end of the fiscal year (although they may accrue a bonus fund to adjust for extraordinary performance at the end of the year). *Retrospective* compensation systems wait for the end of the year to make their decisions. Admittedly, retrospective systems sound more logical – why would you set someone's compensation before you know how they have performed? This is one of those surprising, counterintuitive facts about human behavior and motivation. Retrospective

firms tend to be more internally competitive because they live with the anxiety of unknown compensation decisions weighing on them all year. That's further compounded if they do little or nothing to manage expectations. The lack of knowing creates incentives to lobby, to boost and boast one's own numbers, to compete and to hoard. It isn't surprising then that firms using retrospective systems tend to trust leaders less and be less profitable and team oriented than their prospective competitors. Worse, some retrospective firms tend to defend their systems as the only possible protection against under-performing partners who might otherwise "mail it in" all year. That distrust then tends to spread to other aspects of the firm, eroding their ability to work together. Fortunately, there are fewer and fewer retrospective systems left in the profession, largely because they tend to be outperformed by prospective firms, and those prospective firms tend to have much happier, more cooperative partners.

5. **Bonus Funds**. As noted, many prospective systems have a small, end-of-year bonus fund they use to recognize and adjust for extraordinary, or unexpected, performance. Such bonus funds typically vary from as little as 5% of firm profits, to as much as 15% (the amount tends to correlate to the relative profits of the firm, i.e., more profitable firms are at the higher end of that range, and less profitable firms at the lower end).
But there is a common problem many firms run into with bonus funds: The more partners to whom they give bonuses, the more unhappiness they tend to create. Giving every partner a little bit of a bonus (which is different than letting everyone share in the overall movement of profits for the year – and the two concepts are not mutually exclusive) may sound nice, fair, and team oriented, but it has repeatedly proven to fail. Because doing so tends to satisfy under-performing partners and discourage more entrepreneurial, high performing partners.
Successful firms find that when they give bonuses to a relatively small group, e.g., under 15% of all partners, and they only do it to reward truly extraordinary performance, that they create happier, more productive firms. But what if only a few partners deserve a bonus? They typically pay those partners an appropriate bonus amount, and the rest of the unused funds are put back into base compensation for distribution.

Leadership Techniques:

There is nothing as effective as great leadership in creating and running a successful firm, and there are several leadership techniques that stand out in managing expectations:

1. **Midyear Interventions**. While it is too late for most firms to implement this year, many firms have discovered that one of the most effective steps they can take is to identify problem partners at midyear and have firm leaders (not just practice leaders) talk to them. Typically, firms will identify 5% to 10% of their partners – those who are under-performing, and/or, exhibiting bad behaviors. Leaders meet with them, express concerns about the impact on their compensation if their performance/behavior

continues, talk clearly about what needs to change, and most importantly, try to help them.

Does this technique magically cure performance or behavior problems? No, most firms will be lucky if they fix the problems for 20% to 30% of those to whom they talk. What it does accomplish, however, is that it is probably the single most effective tool for managing expectations and quelling end of year complaints. If someone is warned midyear that they are having a bad year, or exhibiting the wrong behaviors, and there is an honest effort to intervene and help them, almost no one is surprised at year end when there are compensation ramifications. Most importantly, they then complain less and don't infect other partners with their unhappiness.

The challenge with this technique? There are relatively few people, including law firm leaders, who are great at having this kind of conversation. Why? Giving someone constructive criticism without making it personal is one of the most rare and valuable traits of leadership.

2. **Meaningful Goal Setting**. Many firms use some form of individual goal setting process as part of their compensation system. Unfortunately, this is frequently an effort done in form but not function.

   Too often firms fail to read what the partners write, or challenge partners to improve their goals, or help partners with implementation. As a result, partners write perfunctory goals that are the equivalent of saying they are going to eat and breathe next year, as if doing that will be a significant change, or will help the firm improve its market position.

   The challenge is that real goal setting is difficult. To be effective it typically focuses on making hard decisions to prioritize one's time and acknowledge and address weaknesses (something which most normal human beings don't like to do). A great example of goal setting would focus on 3-5 efforts for each partner, using his or her unique strengths that will most benefit the firm and its overall strategy. And there should be a portion addressing his/her weaknesses.

3. **Honest Communications**: It is often said it is rare to find great leaders who lack great communication skills. Not all communication skills are the same – some leaders are gifted at talking to groups, while others are fabulous at counseling individuals. The key question for managing expectations is, do firms have leaders (at the firm, practice and office level) routinely communicate substantive information and meaningful analyses (not just highly filtered, quantitative data) to partners all throughout the year?
   - Are they honest about telling partners when the firm is doing well, and when the firm isn't?
   - Are they skilled at accurately describing what the challenges are and how to address them?
   - Are they open about the financial data they share, or does it constantly feel like they are just spinning selected facts?

A fatal weakness in law firm leadership is avoiding honest discussions, or worse, filling every discussion with useless "Happy Talk" that hides issues, and thereby keeps the partners from focusing, acting and thereby progressing.
One important footnote: While great leaders are honest about data and the problems they face, they avoid blaming individuals in public. They are, however, very clear with those challenged and/or under-performing individuals in private as to how they are doing and what needs to change.

Some firms suffer morale and trust issues because their compensation process fails to manage expectations. Compensation isn't just about setting a number and then defending one's decisions. There are many firms for whom setting partner compensation is a surprisingly easy and smooth process, regardless of whether profits are up or down, because they focus on managing expectations and helping partners to succeed.

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