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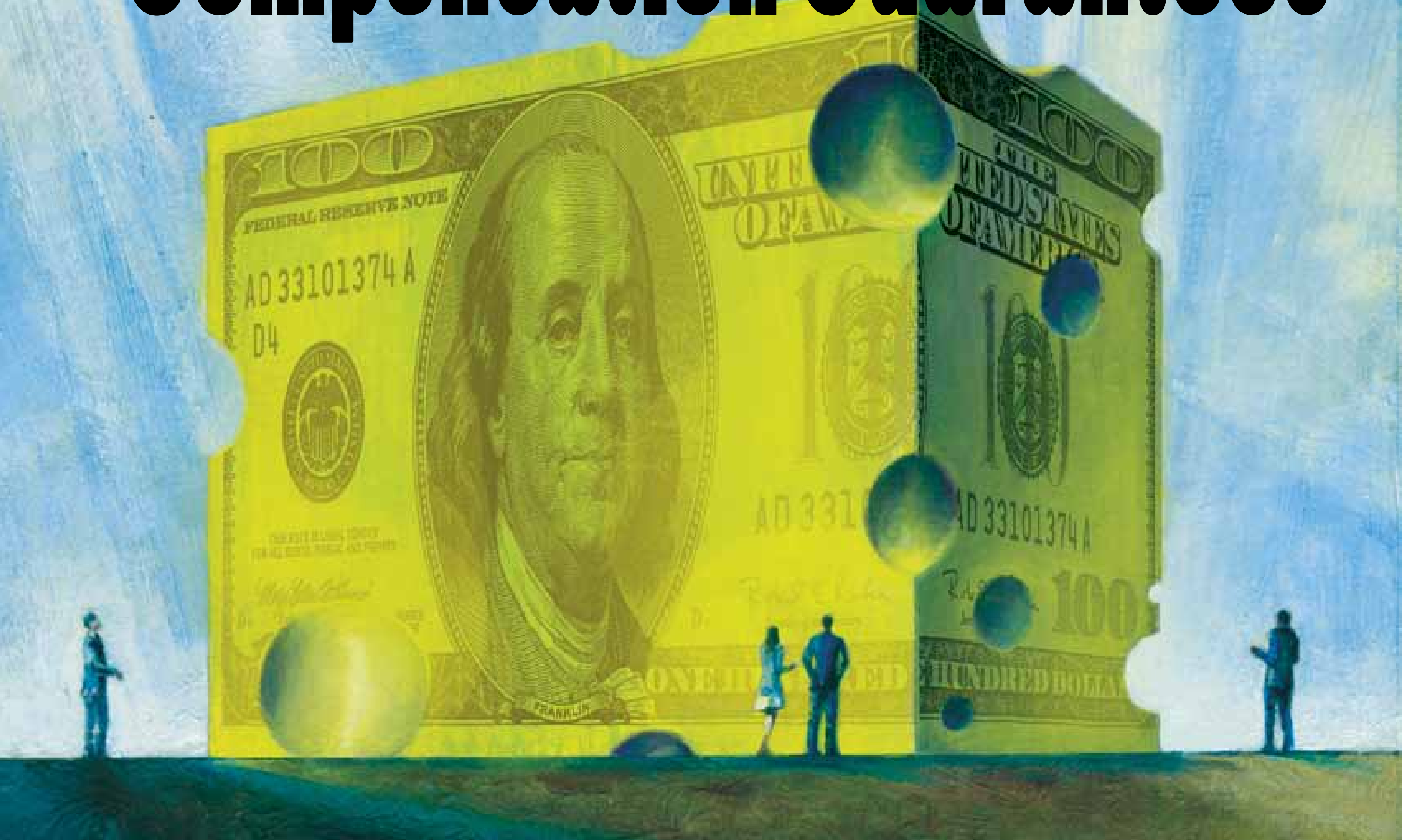
The Question of Partner Compensation Guarantees



Guarantees don't destroy law firms. It is easy to point to guarantees as a cause of Dewey's demise, but it is probably more accurate to look at them as a symptom, because there were so many things that went awry at Dewey.

Are compensation guarantees inherently 'bad' in law firm operations? Definitely not. But just as a kitchen knife is not inherently a bad thing, there is no question that when used improperly, irrespective of good intentions, bad things can and will happen with both knives and guarantees.

Your first area of caution with any partner compensation / distribution guarantee is whether, and to what extent, it may pay a partner more than they have earned under your firm's compensation model, as the model is supposed to be applied to all partners.

A second area of caution with a partner compensation / distribution guarantee is how long the guarantee stays in effect before your partner is fully absorbed into the law firm's compensation model.

As a transition device for integrating a lateral partner, compensation guarantees are viewed by many firms as a legitimate tool. When you bring on a lateral partner you should be able to forecast, with some accuracy, where that partner, with a certain level of business, will fit into your compensation system and what they should earn. "If you do 'X' then you should receive 'Y' has to be part of every lateral hire conversation. Done properly, the guarantee is both a protection against the firm underperforming for the lateral and against a lateral over-representing how he /she will perform.

As we all know, the world is an uncertain place, and disappointments with lateral hires who underperform are pretty high. But

it works both ways. It is your task is to place the incoming lateral into the hierarchy of your compensation model and forecast what the income will be. But, what happens when the compensation being offered isn't enough to get that lateral candidate to come to the firm? Here are a number of areas in which that compensation guarantee can become a real problem:

1. When it assures a partner a level of income that is not achievable.

A guarantee that serves as a backstop against underperformance by the law firm, for a short time such as one year or two, and is measured against delivery by the partner of his or her hours / billings / collections goals, is not an unreasonable feature of any transitional compensation arrangement. Eventually, however, every partner should fit within the same system, and be fit into the hierarchy of compensation fairly with all other partners who perform similarly. To pay two people differently for comparable contribution to profitability can be controversial, and if it is a significant difference it can become cancerous.

A guarantee that is problematic is the one that assures a partner a level of income that the firm knows or should know is above that achievable. This is a decision by leadership, usually without wide disclosure, in a closed compensation system, to subsidize the compensation of the new partner addition with a reallocation of income from the other partners – who don't themselves have guarantees. This is a zero-sum game. The money has to come out of somebody's pocket, and the pockets it usually comes from are the other partners. Naturally how much and from whom depends on how and when the guarantees are triggered and become operative, and that can quickly become very complex.

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How does this happen?

One instance is when a firm assumes or represents it is on an upward trajectory for partner income. The firm aspirationally justifies the guarantee as expiring at a point in time where the firm will be performing at a level which meets or exceeds the guaranteed level of compensation. The firm expects to underwrite the 'excess compensation,' in the first couple of years, because it has a strong desire for the new partner's business and / or practice type. Of course that then becomes a future problem when the rest of the world doesn't cooperate and your firm doesn't succeeded in meeting its net income goals. Then you have to reset the partner to a lower level, which could trigger his / her departure and a financial loss for the firm (especially if a recruiter fee was paid for the deal).

2. When it assures a level of income based on different operating ratios.

Another area where a compensation guarantee becomes problematic is when a lateral comes from a firm that has a significantly higher operating margin. All things being equal (they never are, but let's do this for illustration) a law firm with a 40% operating margin can afford to pay its partners more for the identical book of business than a firm with a 20% operating margin. Like twice as much!

Let's say George has a $10 million practice with a strong 40% operating margin in a law firm with that same margin. George will often be diluted by laterally moving his practice into a different firm with a 20% operating margin. Why? **Because relatively few law firms compensate based on contribution to profits.** Instead firms historically compensate based on gross revenues. Rather than reconfigure their entire internal compensation system to one based on individual partner profit contribution (and possibly resulting in a significant pay reduction for high volume / low margin practice partners) the partner candidate receives a guarantee so that he / she can receive a comparable income to what they were earning in a firm that could afford to pay it. In some cases, the pay package has to be even more than that to get them to come. Thus it must be recognized that the challenge in this situation isn't with the newcomer, but rather it is a struggle to maintain what is an inequitable allocation of income already existing in the new firm.

If the new partner's practice is profitable enough to generate a net distributable income sufficient to carry his / her compensation and allocated costs, even if the guarantee kicks in, it is still a 'win' for the law firm. But what happens if notwithstanding strong performance of the new addition, there is a requirement for the law firm to step up and make a guarantee payment to the partner, and the impact to the firm is 'out of pocket'?

If the acquiring firm is large enough, the 'tithe' from other partners to subsidize guaranteed payments is spread widely and individually bearable. But that will hold true only to a tipping point where the partners

paying that tithe themselves begin to reach a position where they would be better off leaving the firm to join another, where their business will be better paid for. This occurs as the impact of shifting the income allocation means **that the operating margin of the firm is further reduced relative to their compensation** as to this class of partners bearing the 'subsidy tax' to enhance compensation for others.

The result can be that your higher margin practices, the ones you should want to keep are precisely the ones most motivated to leave, if they themselves do not have a guarantee. To protect against that, guarantees may beget more guarantees, which further leverages up the income allocation pressure.

It should not go overlooked that operational superiority, which involves not only 'efficiency' but 'effectiveness', is a huge competitive advantage, and firms that do not possess it are at a serious handicap in being able to attract, as well as retain, talented lawyers with strong client books of business. (It is also very hard to achieve, so law firms have resorted to all manner of internal gymnastics with their structures and procedures to compensate).

3. When it brings pressure on the firm's need to report higher incomes.

A true compensation guarantee, one that guarantees a partner a minimum distribution irrespective of how the firm performs as a whole, is contrary to any traditional partnership ethos of 'we are all in this together'. While partnerships may have different levels of participation, the fundamental principle is that everybody rises and falls proportionately **together**. Guarantees break that relationship and disrupt the culture. They provide the guaranteed partner with an unrealistic safety net that . . ." if we do well we rise together, but if we don't then no matter, I get mine and my partners can pay for it."

Apart from the cultural schism this creates, there is an operational problem as well. Actual financial performance of the firm is not capable of being forecast with any real assurance two or more years into the future when the guarantees may be called. One can forecast to within a percentage point or so around October 1st of most calendar years ending December 31st. By mid year, with some ability to make midcourse corrections that will impact year end results, you really shouldn't see outcomes that are more than 10% off . . . again assuming something unexpected doesn't happen, like having a sequence of major litigation matters resolve unexpectedly, your largest client changes firms, or merges out of existence and the work goes to the acquiring firm's counsel, etc. But forecasting with any kind of certainty two years out, let alone four years out is problematic.

Accordingly, the precise impact of all guarantees outstanding for a term of more than one year cannot be forecast as to the financial impact they may really have on your firm. The tougher it gets on the firm's overall profitability, the harsher the impact may be on the partnership to step up and pay on those guarantees – at a time when they are already feeling the pain of their proportional share of the reduced profits.

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The most devastating effect on your firm's morale and institutional glue happens when two years out your firm is down ten percent on distributable profits, and your partner see guarantees going out to six of the top ten most highly compensated partners – amounts likely to be robust and going to those partners perceived to be best able to weather any financial adversity.

IN CONCLUSION

The guaranteed compensation tool, when it gets too prevalent, too great in magnitude, or used for purposes beyond a short transition period for the partner(s) coming aboard, especially if it triggers guarantees to persons already partners in your firm who demand that if Ms. Newbie gets one then they deserve to have a guarantee too, becomes dangerous. It's akin to holding that kitchen knife at the wrong end.

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