Splitting the pie, some thoughts on profit sharing among partners

According to the great David Maister "profit sharing arrangements between partners are among the most difficult set of issues in professional service firm management". The way partners share profit goes right to the heart of a firm, what it values, behaviours it seeks to foster and reward, the way it defines and recognises contribution and the people it chooses to promote. There is no doubt about the difficulty of these issues, nor is there any about their importance.

Profit sharing arrangements are inextricably linked to partner entry and exit, further complicating both complexity and importance.

First the facts, contemporary alternatives

Individual sharing models vary from firm to firm. They can all work and they can all fail. Most models are a variation of the following.

Equity based sharing (equal or differential) with valuable goodwill

This model endures as the most popular model in the common law world. Most law firm partnerships have fewer than 6 partners. Partners are usually appointed internally from the ranks of associates. Firms are funded by partners. The volume of partner exit and entry transactions is relatively low and they are infrequent.

Under this model a partner's interest is valued, ideally using a formula based on sustainable profit but usually by the firms accountant using a variety of methods that range from precedent to "using the force". Profit is almost invariably shared equally although some firms have differential ownership, allocating profit commensurate to ownership.

This is typically a small firm model. It places strategic limitations on firms and, although it has endured for centuries its appeal to the next generation of partners remains to be seen.

The idea of valuable goodwill in law firms has received a boost in recent years with the advent of publically owned (both listed and non listed) law firms. These firms are demonstrating growth by acquisition intent, paying multiples of profit to current owners. Although limited to a small number of transactions to date it is difficult to argue that goodwill doesn't exist when there are people, external to the firm paying for it.

Strengths

- an opportunity to build an asset
- tenure, security and "sovereignty"

Weaknesses

- uncertainty of realisability of the asset
- limitation to merger
- limitation to lateral recruitment of partners
- difficult for incoming partners to fund purchase usually at an expensive time of life

Lock step to equality

In a pure lock step firm, lock step describes the means by which a new equity partner acquires his or her equity. Such a firm will typically admit new equity partners every year. New partners usually contribute capital equal to the amounts contributed by all equity partners.

In their first year of equity new partners receive profits of an amount equal to 35% to 50%, depending on the firm of those received by the full parity partners. The timing of progression varies from firm to firm although allocations are usually for a twelve month period. In all lock step firms lock step partners progress in locked step with fellow entrants, acquiring an increasing proportional entitlement until they reach full parity. This progression takes 5 to 8 years, depending on the firm. Full parity partners all share equally.

Equal sharing is rooted in the nature of partnership. Partners contribute capital equally and share business risk equally. Equal sharing firms accept that, at times some of their specialised services will enjoy greater or less demand than others. Equality offers highly specialised lawyers the opportunity to minimise longer term risk by partnering with other specialist providers. As commercial advice, such as corporate merger and acquisition services cycle with economic activity, litigation based services, such as insolvency litigation enjoy counter cyclicality. Those committed to equality believe that such risk mitigation will provide better financial outcomes over sustained periods.

In large part individual performance in such firms is regulated by social control mechanisms. Performance is measured across a range of parameters. High performers are acknowledged by the partnership and enjoy high status among their colleagues. Sustained poor performers are usually counselled and on occasions sanctioned. In extreme situations underperformers may be asked to leave the partnership, even the firm.

Advantages

- affordable for incoming partners
- consistent with joint and several liability
- all partners benefit from referring clients and delegating files
- recognises that senior partners will contribute differently to younger partners
- minimises risk as some services experience less demand than others
- everyone benefits from the firms brand equity equally

Disadvantages

- possibility of shirking
- any dissatisfaction is usually felt by the best performers
- offers no financial benefit to partners who wish to do more
- relies on social control to prevent agency problems

Performance based sharing

Performance based sharing models vary from firm to firm. Generally, individual partners are assessed against a set of performance criteria. These criteria usually include financial performance factors, leadership, business development activity and other strategic considerations relevant to individual firms. Individual firms attached different weightings or significance to each of these generic performance considerations.

New partners usually contribute capital equal to the amount contributed by all partners, thereafter sharing according to their relative performance. Under this system any partner, new or senior may receive the maximum profit allocation, subject to performance.

Some firms assess performance and adjust compensation annually. Individuals are usually assessed by a remuneration committee. The assessment process usually involves a submission by the partner under review and is often open to appeal. Other firms require sustained high performance over a number of years before compensation is increased. In these firms they prefer not to assess the entire partnership annually, instead making adjustments to relative shares as needs dictate, sighting significant monitoring costs inherent in annual assessment as the primary reason for their chosen model.

Performance based models have enabled aspiring mid tier firms to grow their partnership through lateral recruitment, introducing partners from outside the firm. These partners are usually attracted to a profit share system that maximises their return for their perceived effort. This phenomena has enabled some mid tier firms to grow at annual growth rates in excess of 50% for the last three years.

Advantages

- recognises over and under achievement
- provides the incentive of direct financial benefit
- attractive to hard working, young partners
- partners can earn bigger incomes earlier
- attractive to lateral recruits who feel disadvantaged under different models

Disadvantages

- introduces risk to specialisation
- requires close monitoring
- assessment may not be seen as equitable by all partners
- delays profit distribution until profit is allocated
- can encourage hoarding of clients and files as relativities become more important than absolute performance
- no formula can capture all aspects of performance
- any formula selected will necessarily prioritise aspects of performance which may cause neglect of others
- erodes collegiate culture

Hybrid Lock Step Schemes

While the skeletal framework of the lock step remains, progression is no longer dependent on time alone. Many hither to pure lock step firms have introduced the possibility of advancement ahead of time for high performance and regression for poor performance. Performance gates have been introduced at intervals along the traditional lock steps. This has the effect of ensuring that partners do not progress beyond a certain step unless they meet performance criteria, effectively “parking” partners for a period of time or permanently and, quite significantly individualizing the process.

Some firms create a bonus pool that operates in conjunction with the traditional lock step. The relative size of the pool differs from firm to firm. The bonus is allocated annually, usually by a committee of partners that considers both the relative subjective and objective contribution of all profit sharing partners.

Lock step has at its core the concept of entering partners all progressing in unison over time. It could be argued that any hybrid lock steps are in fact not lock steps at all but a differential sharing arrangement that includes time in partnership as a major performance measure.

Advantages

- recognises that all partners are not equal
- provides for recognition of outstanding performance
- allows for differing levels of contribution
- affordable for incoming partners
- provides for “slow down”, part time contribution and greater flexibility
- provides flexibility while maintaining culture of equality

Disadvantages

- all partners must be regularly assessed
- recognises contribution that is less than equal but not greater than equal
- requires the majority of partners to progress to full parity (if everyone elected to stay at 60 points out of 100 and worked less, all would suffer)
- sometimes used to manage parenting or special leave, seen as punitive and harsh

Discussion (not advice)

What are we seeking to achieve, fashion or strategy?

There is little doubt that as firms commercialise, evolving from collegiate fraternities to professionally managed businesses most have embraced some form of performance based compensation for partners.

Many commentators, advisors and academics maintain that performance based sharing is consistent with modern management and motivation theory; "give 'em an incentive, a reason to perform and stand back." Theoretically we all respond to financial incentive by changing behaviours and improving performance. Oddly enough many firms that share profits equally outperform those that do not and many don't. In fact there is a poor correlation both nationally and globally between profit sharing methodology and firm performance.

Profit share (and partner entry/exit) should be strategic. It should have as its reason d'être a set of aims and objectives. I often encounter firms who's sharing methodology has morphed over time, not to achieve strategic business goals but to plicate angry over achievers, this year. Similarly I encounter firms who plough on with equity based sharing (cutting the pie relative to ownership) or equality, regardless of prolonged performance differences within the firm.

There is a stack of learned literature that details workplace motivation, what drives us to succeed. True, it varies from person to person but I suspect that people are not born with a set of motivators. They are conditioned. The desire to rise, for instance is probably significantly stronger for someone who spent their childhood in poverty than it is in someone who enjoyed a comfortable existence on Sydney's North Shore. Sure, parental pressure can whip up a desire to rise so to can many other phenomena, my point is that it is conditioned not innate. Of cause conditioning can occur over short time frames. In my experience partners that earn seven figure incomes become conditioned to them phenomenally quick!

Despite this, most professional service firms do not offer performance incentives to employees. We usually pay a salary, negotiated annually in a performance review that reflects market worth and internal relativity more than individual performance. To complicate this, in recent years the direct consequence of not achieving budget performance has been a pay rise.

We take employed practitioners who have never before encountered performance based pay, never been directly compared to their peers and expect them to thrive in a performance based partnership. Strangely many do but sadly the majority do not.

If we sampled a group of law firm partners and asked than why they became lawyers in the first place, I bet that few would say; "to make heaps of money". The answers would vary but they would include altruistic reasons, prestige, never ending challenge, ego, love of the law and so on. For many, promotion to partnership is more about perceived career achievement than money. How else could one explain the commercially fascinating construct of non equity partnership, a position that encompasses joint and several liability with your employers.

We all know that objectives and motivators change over time, money becomes important to most at some stage in life. We become partners so we can be business owners and every business owner wants to maximise their profit, apparently.

I would contend that professional service firms are quite different to other types of businesses and that generalising industry theory into the professional service firm world could be both wrong and dangerous. There are even differences among professionals. Nobody likes a complicated formula more than an engineer, accountants don't understand why anyone would be motivated by anything other than money, dentists actually aren't motivated by anything other than money, doctors have been done over by the government and forgot what money looked like years ago and the vagaries of patent attorneys remain the best kept secret in the country.

Maximising the performance of partners is likely to involve offering them what they were seeking when they became lawyers and subsequently partners, not just pay as a function of their monetary performance. This necessitates a wide definition of performance and a necessarily complex system to monitor and reward.

Firms that have enjoyed great success with performance based pay usually commence performance based pay at the commencement of a career. In other words they condition their potential partners to thrive, long before they become partners.

Perhaps you should determine what you want to achieve as a partnership. I would counsel against changing from equality to something else because "everyone's doing it". What do you want your culture to become, what behaviours do you want partners to exhibit and staff to learn, how are you going to choose the next group of partners and of cause, how much money do you want to make. You should then build your profit sharing methodology around these aims so it helps to create success, tells your staff what you value and what you seek to reward. You should then tailor a similar approach to professional staff compensation. Those who don't fit will have left long before they are considered for partnership.

Leaving aside the top tier law firms, there is little doubt in my experience that performance based sharing is usually implemented defensively, as a retention tool. "We need to pay Barry more or he'll go and we can't afford to lose him". In some cases it may be catastrophic to lose Barry but it usually isn't. Barry may go as a result of quantum but rarely as a consequence of methodology unless the firm's current methodology is unequivocally unfair. There may also be a good reason to recognise and reward Barry but this can be done within the framework of a lock step. There is nothing wrong with one off or regular prizes and rewards, they make good sense to me.

Redesigning the profit share system to attempt retention is likely to be unsuccessful. FMRC voluntary attrition figures are no better among the performance based sharers, in fact they are worse, for both partners and staff.

I am neither for nor against any particular sharing methodology, I know they all work and they all don't work; there is no best method. I also know that the success of any method chosen will largely depend on the culture of the firm, history and relative success.

I would encourage partners to hasten slowly and design a system for all the right reasons. A friend of mine told me an anecdote when he was the chairman of his firm, a major New Zealand law firm. He had recently attended an international managing partner's forum in the USA. He recounted the envy with which he and his New Zealand colleagues where regarded because many had stuck with lock step to equality. "All of the Americans", he said "changed to performance based sharing and they now long for the simplicity of equality, but they know they can't go back".

When does lock step to equality work?

Equality is not easy. To succeed it requires understood social control mechanisms, good leadership and institutionalised collegiality. Overachievers need to be acknowledged and underperformers managed. If either are neglected or ignored partnerships can develop conflicting factions. Partners like to know that someone is in control of these issues.

Successful partnerships that share equally have usually grown up together, literally. They usually recruit graduate solicitors promoting them to associate and ultimately partner. These firms effectively operate an up or out tournament to success. Employed solicitors compete for limited partnership positions. They are successful or they leave. This sounds harsh but it is common to all of the world's great professional service firms.

The great majority of partners were employees of the firm for many years before they became partners. This has an obvious impact on culture, it's rusted on.

In smaller firms tournaments to success are not always practical. Often smaller firms need to recruit laterally at associate and partner level, sometimes recruiting over long serving employees. In this circumstance equality will succeed if cultural fit is the primary recruitment test. Many laterals find it hard to succeed in a well established firm, equality or otherwise. They are however more likely to succeed if they quickly become recognised as “family members”.

It is also true to say that the higher the profit, the more likely partners are to be satisfied with equal sharing, in my experience, cynical but never the less true.

The role of managing partner is critical to success in equal sharing firms. In my view managing partners should manage partners. It has been my experience that this is seldom satisfactorily done by employed practice managers, no matter their title. I will evidence this with the recent history of the top tier of the Australian legal profession. Not one firm has retained a non lawyer CEO. Although their profit sharing arrangement may differ they all have a partner as their senior executive. In the most successful of these elite firms the managing partner has been a partner of the firm for many years.

When does performance based sharing work?

Performance based sharing often works well in circumstances similar to the above, but that’s the easy way out.

Performance based firms are more common among top and mid tier firms than lock step firms, significantly. Interestingly though of the four most successful large firms in Australia two share profits with a lock step to equality and two have performance based sharing. The same is true in New Zealand and in the United Kingdome.

Most but not all successful smaller performance based firms are first generation firms (the partners that put them together are still there), others have experienced significant growth in recent years. They are often a product of merger and growth has been achieved over a short timeframe by employing lateral recruits. There are of cause exceptions to this but many firms have followed this path, expanding into multi location, some international firms.

Large performance based firms see their profit share system as an important tool and have evolved to performance from equality to take advantage of the flexibility inherent in performance relative to equality.

The most successful performance based sharers have either a totally transparent measurement and reward system or a trusted arbiter/s sitting in judgement. Nearly all of these firms have an appeals process as a part of the system.

I have heard of a top tier firm partner who turned up for his performance discussion with his wife because “she’s a better negotiator than me” and another who includes in his annual written submission, among other achievements, chief fire warden of the building. It isn’t an easy process and requires excellent leadership.

Measurement and monitoring, what to measure and when

I had lunch with a lawyer recently who had been booted out of his partnership (he is a successful family lawyer, a service offering deemed inconsistent with the corporate aspirations of his firm of 30 years). This lawyer had recently established a new boutique law firm with his fellow bootees.

As is often my experience his initial bitterness soon turned to joy. “I’ve never been happier Neil” he said “do you know why?” enthusiastically answering his own question in the manner of the truly enlightened, “sovereignty!” Don’t let anyone tell you that it’s not good to be the king.

The utopia of true freedom, being left alone to do what you want to do when you want to do it is rarely realised by professionals, let alone sovereignty; clients see to that long before partners interfere. That said we do enjoy a high degree of independence and relatively low levels of accountability as partners. We don’t have to ask permission to duck off early, come in late, go and get a haircut, take the kids to their sports carnival and so on. Similarly we seldom have people looking over our shoulder, questioning our advice, workload, pricing or communication style. It’s not quite sovereignty but it is good.

A good partner performance monitoring system should not intrude on the freedom we can enjoy as partners. I would go as far to say it should foster it. Peer review is a coaching process. It should bring out the best in partners, not crunch them. In a good system partners look forward to the process and enjoy it.

In my view a good system is a balanced system that applies equal weighting to a range of performance criteria. Some will pertain to the management and leadership of staff, some to the management of clients and some to financial management and performance. In a performance sharing system this should occur at least annually. In a lock step system it can occur by exception. In other words if partners are performing at expectation, leave them alone unless they request a review. Those who exceed expectation should be acknowledged publically and those who fail to meet expectation should be subject to prompt review. Many firms however recognise the importance of maintaining the performance of the average so all partners are involved in annual reviews regardless of their relative performance.

Sanction for underperformance needs to be managed. Partners who have been reduced from equality or had their profit entitlement downgraded usually feel it deeply. Sanction is often as cathartic as expulsion. In good firms sanction occurs with the consent of the partner concerned.

Gender and generational issues

For over twenty years the majority of law school graduates have been female. Female, full parity equity partners are however a scant minority in most partnerships. In recent years the gender balance of graduates has been disproportionately tipped in favour of females. If firms are to continue prospering partnership structures will need to take into account the needs of women lawyers.

By virtue of their employment brand top tier firms will, more than likely always find graduates to fit their requirements. Other firms that compete for the rest of the graduating class and early career lawyers will have to develop their systems to suit the changing needs of future generations of partners, most of whom are likely to be women.

Fortunately the profession has had a reprieve from the exhausting demands of generation Y. In fact, as I move around the profession I hear tell of the quality of recent graduates, no baggage, prepared to work hard, prepared to work long hours when clients require it and so on. That said smart firms are still moving to meet the needs of younger lawyers, money, flexibility, egalitarian cultures and so on. Partnership structures and sharing arrangements should reflect this.