

Legal Management Services, Inc.

Helping attorneys create financial independence

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Owner Compensation

By: Jerry Schwartz, President of Legal Management Services, Inc.

For many firms, compensation issues are some of the most difficult issues to deal with in a law firm. The difficulty is not entirely a law firm issue. Many of the problems stem from an unrealistic expectation of the amount of distributable income that the firm can generate to pay the partners. The best place for a law office to start when considering the adoption of a new compensation system is to ask the partners to do some soul searching regarding their expectations for income from the firm. Have the partners purchased houses or land that requires high mortgage and maintenance payments? Do the partners have second houses in the country or at the beach? Have the partners leased or purchased vehicles that have high monthly payments? Do the partner, partner's spouse and children spend freely on credit cards with no control? Are the partner's children enrolled at the most prestigious schools? Do the partners personally travel frequently? These expenditures are not bad but they contribute to the pressure of the partners to expect a higher firm distributable income than it may be able to generate.

In order to become realistic about distributable income, the individual partners should prepare a personal financial plan or a budget to determine their needs. This plan should not be discussed with fellow partners because it is not their concern, but it does establish a benchmark for the individual partners when they begin the process of developing a new compensation

system. It can determine that the problem with compensation is not a firm problem but a problem of the individual.

Once the partner's expectations are determined and providing that the law office is profitable, each group of lawyers must face the task of determining how to distribute the profits. This can be a very simple or a very complicated procedure and probably should fall somewhere between. One of the main criteria of the profit distribution system should be to strengthen the partnership. A partner is defined by Webster's New World Dictionary as 1: one of two or more persons in the same business enterprise, sharing its profits and risks and 2: a player on the same side or team. Lawyers that fail to give any weight to the second definition are creating problems for themselves and the law office. Many compensation systems are designed to compensate lawyers solely on a formula basis. Some of the formulas are as follows:

- Equal: Each partner receives an equal share of profits and losses.
- Ownership: Each partner receives the same portion of profits and losses as the ownership percentage.
- Production and Origination: Each partner receives a percentage of profits and losses based on an average of lawyer's percent of production and origination as compared to the total law office production and origination.
- Fees to Gross: Each partner receives a percentage of profits and losses based on the percent of the lawyer's fees to gross fees.
- Production less Expenses: Each partner receives an amount of profit and loss equal to the lawyer's production less the expenses of the law office distributed equally or in some other proportion.
- Seniority: Profits and losses are distributed based on firm longevity.

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Formula systems do accomplish the goal of distributing profits and losses; however, they do not encourage the development of partnership as a team. The following are problems of using formula systems:

- They do not properly value the individual strengths that each partner brings to the partnership.
- They focus the partner on individual compensation and not on the good of the firm.
- They do not recognize the value of management, training or compatibility.
- They do not promote sharing of work or cross selling of services to clients.
- They tend to invite manipulation of the compensation system.

The following criteria are important to the law office as a partnership and should be considered in any compensation system. Different weights may be given to the various criteria, but all should be considered.

- Production and Profitability of Work - Lawyers have an obligation to the firm to accept profitable work for the firm. The decision to do "pro-bono" work should be made by the partnership and not the client. Lawyers should also be paid based on the collections produced from their work product.
- Asset Management - Lawyers should manage the work in process and bill the client when appropriate. Proper follow up should be accomplished to ensure collection of the accounts receivable.
- Client Origination and Client Retention - Lawyers must develop business and maintain their client base if they are to be successful.
- Management and Training - Lawyers that have the ability to manage and train should be compensated for the time they spend on firm management and training which would have been spent on client matters.
- Risk and Investment - Lawyers that have a contributed capital balance should be

compensated for their investment in the firm and the founding partners should be given consideration for the sacrifices made in the start-up of the firm.

- Technical Contributions - Lawyers with special skills should be recognized for their talents.
- Outside Activities - Lawyers that spend time working in professional and community activities to further the name of the law office should be credited for the time which could have otherwise been devoted to client matters.
- Compatibility - Lawyers that contribute to a smooth running office should be recognized for their cooperation and the good working atmosphere they help to create.
- Delegation - Lawyers that transfer work to the highest level of competency and those that complete the delegated task should be properly compensated.
- Seniority - The wisdom that only comes with experience should be acknowledged in the compensation system.

These are many of the criteria that should be reviewed as contributing to the overall success of the law office. The main idea should be to give credit to the strengths people bring to this association. Some lawyers will take the opportunity to use the subjective criteria as a means to discipline their partners. Discipline should take place at a meeting of the managing partner and the individual not at the time of determining compensation. This process requires an open and fair mind and should be a method to encourage and compensate the strengths of the people we call "PARTNER".

As a first step in the development of a new compensation system, the partners should rank each of the above criteria. The partner responses should be averaged to see what criteria ranks the most important to the partners. A compensation system is then built around the areas of importance

to the firm. A salary and/or interest on capital balances can be used as an additional component. In addition, five to ten percent of distributable income can be held for the partners to make subjective distributions. Pocketbook issues are difficult issues to decide, however, if all keep an open mind it can be a method to build the partnership.