

PARTNER REMUNERATION SYSTEMS

A key to fluctuating profit levels

(Aug 05)



Going into print on partner remuneration systems is treading on dangerous ground as NZ, unlike most Common Law jurisdictions, considers this to be a highly sensitive area.

However, there is no need to panic, this is not going to be an exposé on profits in \$s and cents but a comment on how the method of profit distribution and fluctuation in profit volumes are linked.

One primary indicator stands out when looking at consistent high profits for distribution in any law firm:

- Continuity

Where profit growth is seen to be constant (smooth) there is a strong likelihood that the distribution system is seen to be equitable **in the long term**. Conversely, where profits fluctuate there is a strong likelihood that one or both the following is occurring:

- High relative levels of partner turnover
- High levels of profit related pay

Whilst LegalBestPractice have yet to set out empirical research on this there is considerable evidence to indicate the higher the percentage of profit-related pay the more those profits will fluctuate from year to year.

It is worth remembering that profit distribution systems that relate personal income to perceived contribution to profits is a new variant on what has existed for hundreds of years. Partnership as an operating structure has been around since the 17th century and for most of that period profits have been distributed on a basis of equality, whereby all partners are considered equal. It is not that long ago (i.e. within my professional life) when many partners received equal remuneration from the day when partnership status was conferred, this being the natural extension of joint and several liability. For much of the twentieth century the lock-step distribution system prevailed, whereby parity of drawings was achieved after a defined period of time as a partner has been served, the period varying between 5 and 15 years.

The introduction of profit related pay has tended to ignore a significant and uncontrollable factor in a firm's economic performance – macro-economic change. This has a profound influence on profits for distribution. Consider for a moment the factors that influence high levels of property transactions – increasing values accompanied by affordable borrowing rates in a climate of seemingly sustainable demand. The market goes crazy and the overall percentage of law firm profits attributable to property transactions rapidly increases. It should be noted that in jurisdictions where governing bodies require financial returns (i.e. everywhere but NZ!) it is possible to look at and measure overall change in profits from specific specialisation over time, profession wide. Changes in profit volumes reflect macro-economic variation, e.g. periods of abnormally high interest rates are followed by increases in the volume of litigation as credit availability declines. Work flows follow changes in overall economic activity, usually 'lagging' by 6-9 months (e.g. a decline in new building work takes about 9 months to be reflected in lower volumes of conveyancing.)

Under the 'old way' of profit distribution the prevailing attitude was 'steady as she goes' and partners/staff in areas of high demand worked harder/longer and others helped out when and where they could. There was a fundamental understanding that what was 'hot' one year might not be in the next. Income from areas of high demand did not accrue to specific partners but to the firm as a whole. Introduce profit related pay and the balance is undermined, with partners working in areas of high demand expecting larger rewards. This admittedly oversimplified example is only part of the situation. The other factor is the 'rainmaker', or partner who carries with them a 'tail' of clients and an above-average fee income. For the last 15 or so years some of these people have carried a 'premium' when it comes to personal drawings resulting in disruption and resentment among their peers. In reality rainmakers can

rarely justify their status permanently as once again cyclical changes in macro-economic activity erode their capacity to continually deliver higher profits. This can have two outcomes:

- Increased partner mobility
- Bottom-feeding (partner chargeable hours high – assistant hours low)

This latter factor should be considered alongside the inescapable fact that the greatest influence on a firm's profits is the number of assistant solicitors per partner – not individual partner billings.

At a practical level earnings related pay can be reasonably effective BUT to be successful two factors need to be present:

- Partners must accept that their personal incomes will fluctuate year to year (i.e., rise and fall)
- The profit-related percentage of personal income should be limited.

To those of you who may be interested in knowing what level of earnings-related pay is too high our answer, based on 15 years' experience of detailed observation, is 15%. This figure has the appearance of being a 'trigger' point at which motivation and partnership cohesion become a real problem.

High partner turnover and wildly fluctuating profits are avoidable. To learn more contact our office.

By way of a post script to this story it has just come to my attention that one of the founding partners of a major German-based multi-disciplinary partnership (law, accounting & tax) Haarmann Hemmelrath has announced his intention to quit the 1000 partner practice at the end of this financial year as a direct result of the introduction of the 'eat what you kill' culture that developed following the move from lock-step to earnings related pay, earlier this year.

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