The Revolutionary, Common-Sense Approach to Managing Partner Compensation

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There may have been a point in our history when professional service firms nearly ran themselves. They were small entities, with most of the partners' names on the door. Clients were institutional—they used the firm because they always had, and didn't fret about the bills. Talent stuck—an associate joined out of graduate school and didn't give a thought to leaving until he retired as a senior partner (at the time, it would have been a he). The business plan wasn't quite as simple as "print money," but it wasn't much more complicated than keeping the lights on. Under such conditions, the title of managing partner was more honorific than anything. And the idea of giving special attention to how the managing partner was compensated would have struck the partners as a curious one.

If such a mythical age ever existed, it is far gone. Today's professional service firms ("PSF"s) are not small operations, but multi-million-dollar-sometimes multi-billion-dollar-businesses. A managing partner must face challenges including the upheaval of the Great Recession; its lingering effect on the
economy; significant price pressure from corporate clients; a diminution in loyalty from those clients; greater client access, through the Internet and other means, to information about competing firms; greatly increased lateral movement; the erosion of monopolies allowing only those with professional licenses or certifications to provide certain services; and a business model that is clearly broken.

Despite these obvious changes, the lack of thought given to how professional service firms are managed—and in particular, to how managing partners are compensated—has remained. That inattention is a relic of another time, and must be addressed within any PSF that wants to thrive. The modern challenges noted above require a managing partner to act with the skill and dedication of a true business executive. They also require that PSFs, in order to remain competitive, convince their best executives to lead their firms. These demands call for a new approach to compensating managing partners, one that comports with the complexities of leading a PSF today.

The purpose of this article is to make the case for that new approach—one based largely on common sense, but not widely used. This article will analyze two approaches that have prevailed historically; it will offer a more reasoned alternative; and finally, it will discuss
protections for departing managing partners that are necessary to attract quality candidates for the role. It is essential to distinguish between leadership and management. This article pertains to the compensation of leadership not only management.

**Prevailing Models**

As a legal advisor to PSFs, and having served as a managing partner within my own PSF for 16 years, I have studied many PSF compensation models. Most PSFs compensate their partners with utter disregard to the partner's contributions to achieving the firm's strategic goals and promoting its overall success. Instead, the predominant compensation model focuses exclusively on the partners' achievement of individual goals.

This approach is bad enough when applied to the partnership at large; when applied to the managing partner, however, it is far worse. And yet, many PSFs do just that. For years, PSFs have compensated managing partners like other partners, rather than as leaders of businesses.

Many PSFs favor one of two prevailing approaches: trying to squeeze the square peg of leadership into the round hole of professional services, they compensate the
managing partner on the same basis as partners who do very different things for their firms ("One-Size-Fits-All Approach"); alternatively, they assess the managing partner based on the firm's profitability alone (the "Stock Market Approach"). Neither aligns the managing partner's interests with firm's business strategy, which is critical to effective leadership.

One-Size-Fits-All Approach

The One-Size-Fits-All Approach is based on a false equivalency. Partners within PSFs frequently charge their clients-and have their own compensation determined-by the number of hours they have billed (or the number of hours others billed on accounts they originated). In determining how to compensate their managing partners, One-Size-Fits-All firms lean heavily on the one compensation metric-time-with which they are most familiar. They award the managing partner "credit" for his or her non-billable time. In some cases, the credit system is structured in a manner that misguidedly encourages the managing partner to remain "accountable" to his or her share of the partnership's billables at the expense of leading the firm toward success. In all cases, using hours spent to measure leadership is, at best, a blunt instrument that pays no regard to the achievement of results.
Should leadership be measured by how long a partner can stay at lunch with an "A"-level prospect who may or may not be truly interested? If the firm badly needed to turn around a practice group, but the managing partner is incentivized to instead focus on another $100,000 in his or her own collections, is this good for the business? PSFs that answer yes are, unwittingly or not, embarking on their own private Bataan Death March.

**Stock Market Approach**

Let us begin with an agreement that profits are important and essential. Businesses are formed, to among other things, make profits for distribution to its owners. PSFs adopting the Stock Market Approach seek to focus their management's attention on profits, and for that they cannot be blamed. The problem, as ever, is in the details.

Frequently employing a beloved analogy between PSFs and public companies, the argument for the Stock Market Approach goes that if profits go up, then the managing partner should be compensated accordingly, and if the profits go down, their compensation should be negatively affected, just as public companies leaders are rewarded and punished for trends in their stock. Many partners like this approach based upon the
short-sighted view that it will increase their distributions. It may, in the short term. But Stock Market Approach firms often revel in short-term profit increases only to find out later (often too late) that their lack of forward thinking has stymied their firms. In this respect, they do indeed parallel public companies, which regularly make silly decisions to satisfy investors demanding immediate gratification.

Consider whether the managing partner of a Stock Market PSF would think seriously of reinvesting profits into necessary infrastructure upgrades, technology, or the future of a practice group with great long-term potential. If they do so, they are praiseworthy indeed, because they do it at their own personal expense. Further, greater effort and skill is required by a managing partner during a crisis, change initiative or a turnaround, when the profits are sometimes at their lowest and in the process of a recovery. The Stock Market Approach may be a fine one for partners looking to wring every last dollar out of the PSF before the ship sinks, but not for PSFs that seek to create a sustainable firm positioned well for the future.

The Balanced Approach

While most PSFs adopt one of the two above models, a smaller number have the courage...
to compensate their managing partner based on both objective and subjective criteria (the "Balanced Approach"). The failure of this approach to gain wider traction may be attributed to the fact that PSFs are filled with very smart people who have ample capacity to make a solution more complicated than necessary. Asked to choose among many criteria for setting managing partner compensation—in particular the subjective criteria—they suffer paralysis, throw up their hands, and say "we just do not know how do it."

The good news is this: there's no need to make a federal case out of the matter. Let's simplify by identifying a few underlying assumptions of a reasoned compensation system, and then review how to implement that system:

1. Managing partners should not be compensated based on the system used for other partners; instead, the criteria used to determine managing partner compensation should focus on improvement in the business and its positioning for future success.

2. Depending on the size of the firm, the criteria can include the maintenance of a professional practice, as long as the burden of leadership is considered in
setting the relevant standards. They should phase in over 18 months, allowing a new managing partner to adjust to the new role.

3. The evaluation of the managing partners should include input from the management team, practice group leaders, and the partnership, especially key partners.

4. The criteria established should be evaluated by people, inside or outside the firm, who understand the job of a managing partner and how the PSF wants itself to be led. This analysis will be more subjective than objective, so this group must have the courage to judge.

5. Managing partners should be evaluated on multi-year goals, which should be segmented with milestones and revisited periodically. The managing partner should be judged on progress made towards those goals, as well as the ability to effectively adjust and pursue better options.

6. As the business priorities within a firm change from year to year, the evaluation criteria should change as well. The criteria should be based on a dialogue between the managing partner and the
committee performing the evaluation at the beginning of the evaluation period, and throughout it as necessary.

7. As a baseline, those who assume the managing partner role, compromising their own practices to build the firm, should be paid at least 80% of the PSFs highest-paid partners. The evaluation will determine whether and how extensively a managing partner's compensation departs upward or downward from that baseline. This is where a trained eye will be able to distinguish between leading and managing, the former being the more important part of the package. Anyone can check a task list. Inspiring others takes something special.

8. A managing partner returning to practice should have compensation protection. This is a simple set of principles, none of which are beyond the capacity of a PSFs to implement. It's largely common sense, not brain surgery-the approach advised here is a matter of establishing some reasonable criteria by which to evaluate the managing partner, conducting that evaluation, and ensuring that the people who conduct that evaluation are those most competent to do so.
Establishing reasonable criteria

The Balanced Approach uses a mix of objective and subjective criteria, all of which should be consistent with the long-term goals of the firm. A managing partner can enhance his or her chances of success greatly by working with the firm's governing body (e.g., its executive committee) to define those long-term goals clearly, achieving buy-in from the partnership on them, and proactively developing concrete plans to achieve them (which can help provide milestones by which to judge the managing partner's performance).

Objective criteria might include revenue growth, profitability percentage, the recruitment of key personnel, and the performance of the firm as a whole. Business originations can be a factor in the equation, but if it is weighed too heavily, the managing partner might as well just go back to work full time and dispense with the charade. The other, more subjective criteria, will of course depend on the particular circumstance of a PSF and what it wants to achieve. Regardless, they should not be criteria the managing partner can satisfy on his or her own, but instead be criteria that the managing partner can only achieve by improving others’ performance. The managing partner might, for example, be charged with getting a new CFO
up to speed within two years.

Frequently, the criteria that the firm found important in selecting a managing partner for the job can and should become the basis for evaluating him or her in the job. Any PSF that intends to survive past the next generation should have those criteria firmly in mind, and make them part of a succession plan to ensure a smooth transition.

**Conducting the evaluation**

Assuming the right group is conducting the evaluation (more on that in a minute), it won't be difficult for it to assess the managing partner's performance, and, in turn, compensation. You don't need to be an MBA to understand management by objectives—you either achieve the objectives, have understandable reasons for changing or deferring accomplishment of those objectives, or fail to achieve them.

To be clear, both the first and second alternatives are positives—and sometimes the second alternative is the preferred action to take. Take a law firm that wants to acquire a litigation practice group, and has integrated that goal into its evaluation criteria. A managing partner should be applauded for passing on a contemplated acquisition if and when it becomes clear that is too expensive,
or the deal has other warts on it that threaten the law firm's long-term interests. The evaluating committee would understand that not checking that particular box is an executive decision worth rewarding.

Ensuring that the evaluation committee is competent

Who should be making the evaluation? Probably not the compensation committee, which has expertise in assessing the performance of individual, practicing partners, but not the executive job of the managing partner. It may be difficult for partners to accept that the managing partner is being judged through a separate system outside of the purview of compensation committee, but much of what managing partners do takes place behind the scenes of the PSF, and can only be measured best by those who actually understand the position.

Few do, but the most concentrated group of them in any one PSF will be on its governing body, which makes that the best group to perform the evaluation. In addition, it is a good idea for the group to seek input from an independent former managing partner on the value and performance of the managing partner. If necessary, this person can also teach members of the evaluation committee what it is like to be the managing partner,
relieving the managing partner of attempting to give that explanation without sounding arrogant or self-aggrandizing.

**Protection of Managing Partners**

**Transitioning Back to Practice**

Managing a firm is a consuming task, which when performed with any degree of seriousness interrupts a partners' professional practice. A departing managing partner cannot be expected to simply pick up where he or she left off; instead, the former managing partner should be given a period of compensation protection on return to practice. The rule of thumb that many PSFs use is one year of protection for every three years as managing partner. Like the 80% baseline, this might be adjusted upward or downward based on the success of the managing partners' tenure, the degree of immersion that a particular managing partner role requires, and the extent to which the former managing partner effectuated a smooth succession.

The firm should afford protection to a departing managing partner not only out of fairness, but in its own self-interest in attracting qualified candidates to the role. Ideally, an agreement regarding compensation protection should be made at the outset of a tenure, so that the firm has tied its own hands in advance. If for any reason it
is tempted to treat a departing managing partner poorly, and gives in to that temptation, there are few who will want to follow in the next managing partner’s footsteps.

PSFs need their best people to lead, not the least unwilling. I suspect that was true even in the halcyon days of our imagination. I know it is true today, when the challenges facing managing partners are unlike anything we've ever seen.