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Finance: Splitting the pie with profit sharing among partners

In the first of a series of articles on profit-sharing, Neil Oakes outlines the key models from which law firms can choose.

Neil Oakes

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.

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

This model endures as the most popular model in the common law world. Most law firm partnerships have fewer than six 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 firm's 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 publicly 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 does not exist when there are people, external to the firm, paying for it.

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Advantages:

- an opportunity to build an asset
- tenure, security and 'sovereignty'.

Disadvantages:

- 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.

Depending on the firm, in their first year of equity, new partners receive profits of an amount equal to 35 per cent to 50 per cent of those received by the full parity partners. The timing of progression varies from firm to firm, although allocations are usually for a 12-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 five to eight 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, and even the firm.

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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 firm's 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 attach 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 phenomenon has enabled some mid-tier firms to grow at annual growth rates in excess of 50 per cent for the past 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 hitherto 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

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of time or permanently and, quite significantly, individualising 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.

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