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A New Associate's Field Guide to Partner Compensation

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There's a certain topic of conversation shared among all lawyers, except, it seems, new ones. It's a topic that, as a newly minted lawyer myself, I never asked about—partly from ignorance and partly intimidation. Now that I'm slightly more broken-in as a lawyer, it's a topic I'm asked about frequently by new associates. The topic I speak of is law firm compensation for partners.[1] This topic entails a deeper question of how firms allocate income and expenses among firm owners.

Despite its off-limits perception, profit allocation is an important issue to understand for lawyers new to a firm. Not only does it dictate how one would be compensated as a partner of the firm, but it can also reveal subtle details about the firm's values and goals. This article attempts to provide a basic field guide to the most common forms of law firm profit allocation. It must be understood, however, that there are as many ways to allocate income and expenses among co-owners of a law firm as there are law firms. The summary set forth here is not, and could not be, exhaustive of this topic.

Those who took business associations in law school know the basics already. Law firms are usually organized as a partnership, limited liability company, limited partnership, limited liability partnership, or a professional version of one of these. In general, partnership income and expenses are allocated and distributed among partners in proportion to each partner's pro rata share of the partnership. Limited liability companies, limited partnerships, and limited liability partnerships all permit this type of allocation but also permit deviations from the general rule as agreed among the owners of the entity. In other words, in most law firm settings, allocation of income and expense (and therefore partner compensation) is a matter of contract among the owners. There tends to be three broad models of income and expense allocation; we will call them the "true partnership model," "the modified partnership model," and the "eat-what-you-kill model." Variation within each model is wide and significant. We will survey the basic characteristics of each below.

The True Partnership Model

Firms that utilize this model simply allocate items of income and expense to partners proportionally to the owner's interest in the firm. Consider the hypothetical firm of Dewars

Walker & Ardbeg, LLC. The firm's operating agreement authorizes 100 units of membership interest, which are owned by the three members of the firm as follows: 45 units to Dewars, 35 units to Walker, and 20 units to Ardbeg. The operating agreement provides for allocation of income and expenses among the limited liability company members on a unit basis. During April, Dewars brings in $45,000 in total fees, Walker $20,000, and Ardbeg $35,000. At the end of the month, the firm has netted $20,000 in profit and has $20,000 in free cash available for distribution to the members. Based on their membership interests, Dewars will receive a distribution (before tax) of $9,000 (being 45 percent of the total distribution), Walker $7,000 (being 35 percent of the total distribution), and Ardbeg $4,000 (being 20 percent of the total distribution). For purposes of allocating profit, it does not matter that Ardbeg collected more fees that Walker during the month.

Except in firms that pay partners a "salary" or guaranteed payments throughout the year, as described more below, partners in true partnership model firms generally do not enjoy perfect predictability in the timing or amount of distributions from the firm. The firm, and thus its partners, may be flush with cash some months and receive relatively little during others. The transition from being a salaried associate to a partner at one of these firms can feel abrupt.

True partnership model firms are probably the least common of the three models today. Most firms that follow this model are generally small, likely having fewer than 15 partners. The pros and cons of this model are obvious. On the one hand, partners are not compensated strictly based on their productivity or profitability, although these considerations (and others) usually bear on the determination of partnership percentages. It is not uncommon for such firms to cross-subsidize younger partners by awarding them a greater partnership percentage than would be justified by their annual receipts. On the other hand, partners are incentivized to share clients, refer matters internally, and handle cases together. True partnership model firms largely avoid intra-firm disputes over allocation of expenses (e.g., staff salaries, copier rentals, etc.), which can be sources of strife under other models.

The Modified Partnership Model

The modified partnership is probably the most common model. It is almost certainly the most common among larger firms. It is also susceptible to the greatest variation among firms that follow the model. The modified partnership model embellishes on the true partnership model with the goal, usually, of directly rewarding productivity, profitability or both. In these firms, ownership is often granted initially in a lockstep system that vests partners with set amounts of equity based on seniority. To incentivize junior partners—whose equity stake is often relatively small—to be productive, these firms devise ways to reward high achievers with various kinds of bonuses. Chief among these are the year-end bonus and the origination bonus.

Year-end bonuses are what they sound like—annual payments of additional compensation above a partner's distributive share calculated under predetermined criteria. The usual criteria for year-end bonuses for partners are based on productivity or profitability of the individual lawyer. There are many ways to quantify things like "productivity," and, therefore, there are many ways to calculate year-end bonuses. Productivity is often determined in large part by billable hours, actual receipts of fees (i.e., revenue), or a combination of the two. Origination bonuses are rewards for bringing a new client (or sometimes a new matter for an existing client) to the firm. "Origination," as it is often shorthanded, can be determined in a number of ways. It is typically calculated as a set percentage of the total fee associated with the new client or matter. Origination bonuses can be significant and, as a result, firms often develop thorough and detailed rules for awarding them. Each firm will define "origination" differently—at some shops, for example, origination would include bringing back a former client, whereas other shops would not award origination on a client the firm represented in the past. At still other shops, the origination might be awarded to the lawyer who first brought in the client rather than the lawyer who brought the client back.

At many firms, partners accumulate origination credits that factor into the calculation of a lump sum bonus. Origination bonuses may be paid at the end of the fiscal year along with, or as part of, a year-end bonus. Partners who receive origination bonuses sometimes share a portion of the bonus with other junior partners or associates who contributed meaningfully in bringing in or working for a particular client.

Many, perhaps most, modified partnership model firms also pay partners a "salary" or guaranteed payments. Many firms pay partners a "salary" at regular intervals throughout the year such that each partner's individual cash flow does not change significantly from when they were associates. But partners qua partners do not enjoy a "salary" within the term's usual meaning. Instead, partner "salaries" or guaranteed payments are usually subject to repayment at the end of the fiscal year to the extent that the total received exceeds the share of profits to which the partner is entitled under the partnership agreement. If, on the other hand, a partner's aggregate annual salary or guaranteed payments falls short of the partner's share of profits, the partner will be entitled to an additional bonus to true-up compensation with percentage ownership.

What happens if a partner receives $300,000 in salary payments during 2018 but the partnership share at year end would entitle that person, under the partnership agreement, to only $275,000? In this case, the partner would owe the partnership the difference ($25,000). Likewise, if the partner's proportion of firm profits at year end would total $400,000, the firm would owe the partner $100,000. This year-end true-up usually results in partners getting more from their distributive share than they received in guaranteed payments, in which case, they enjoy the bonus. But stories exist of partners paying the firm back for excessive guaranteed or salary payments.

The Eat-What-You-Kill Model

Some eat-what-you-kill firms may resemble office-sharing arrangements more so than law firms. Shops that follow this model allocate most income and expense items to the partners who earned the income or incurred the expense. Certain shared expenses such as office space rent, copier rentals, Westlaw or LexisNexis and library subscriptions, breakroom snacks (the list of expenses is long!) are allocated among partners based on their proportional use of the expense item. Eat-what-you-kill firms can and often do hire associates; and those associates' salaries are generally allocated to the partners on the basis of each partners' use of the associate's time.

Let's return to our hypothetical firm, Dewars Walker & Ardbeg, LLC, for an illustration. Assume Dewars Walker & Ardbeg's operating agreement provides for items of income and expense to pass through to the member who earned the income or incurred the expense. Assuming the same facts as stated above about the month of April, Walker would be entitled to $35,000 in fees collected but would be responsible for the incurred share of firm expenses. Assume the monthly salary for Walker's legal assistant is $4,500 and that 75 percent of the assistant's working time is spent working for Walker and 25 percent for Ardbeg. Walker's $35,000 in income would be reduced by 75 percent of the legal assistant's salary, or $3,375. The same calculation would occur for all shared expenses the firm incurred during April. Certain expense items are passed through completely to Walker, like Walker's membership dues for the Kansas Bar Association. At the end of the month Walker will receive the positive difference between income and expenses.

Like true partnership model firms, eat-what-you-kill firms are often small or medium sized. Junior partners may find it challenging to make ends meet at these firms. To ease the transition from associate to partner, these shops often allocate a relatively small portion of large expenses, like rent, to junior partners. The major advantage of an eat-what-you-kill system is that it clearly aligns partners' efforts and success with their compensation. Partners who want to make more money can do so by finding more clients and generally working harder.

If you've read to this point but haven't recognized any of these general descriptions as describing your firm, do not be surprised. There are myriad ways to allocate income and expenses. The key for young lawyers is to understand the fundamental differences among the broad compensation models, and to inquire about the specific method utilized by any firm the individual is considering joining. ■

About the Author

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1. We will use "partner" throughout this article to refer generally to an owner of an equity interest in a law firm regardless of the firm's form of organization.