COLE ASSOCIATES CORPORATE FINANCE
WHITE PAPER ON ALTERNATIVE PROFIT SHARING STRUCTURES FOR PROFESSIONAL SERVICES FIRMS
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In this White Paper we explain the most common methods adopted by professional services firms, especially law firms for the allocation of annual profits between partners, the historical background, recent trends and the advantages and disadvantages of each method. We also provide worked examples.

We have a good deal of experience in advising firms on partner remuneration structures, ownership issues and succession planning. If you would like to discuss any of these issues in more details our contact details are set out at the end of the White Paper.

Historical overview

In the UK the historical convention has been for profits to be allocated equally between all partners, regardless of contribution or performance. This is the default assumption in the Partnership Act of 1890 and was felt to be consistent with the principle of joint and several liability. The goodwill value arising from the accumulation and retention of clients was felt to be the *firm's* intellectual property, not the *individual partners'*. During the 20th century this system evolved into the 'lockstep' system which comprises equal allocation, subject only to a recognition of seniority, whereby new partners start on a lower share of profits and increase their share over a period of time (for example, 5 years) until they reach the top level, or 'plateau', where they remain until retirement. Under the lockstep system there is no distinction between partners' individual contribution to the business or performance. An example of the lockstep system is set out in the section on Lockstep below.

In the U.S. the historical convention has been for an entirely merit-based system, the most extreme expression of which is the "eat what you kill" principle. 'Merit' has traditionally been associated with financial measures, principally work won/billings. Advocates of this system point to the benefits of motivating each partner to be a 'rainmaker', and penalising poorly-performing partners who could, in theory 'drift' under the lockstep system.

Since the 1990s there was a move in the UK towards 'hybrid lockstep' systems, or 'managed lockstep', whereby partners can move up or down the lockstep for reasons other than the passage of time; we explain these in more detail below. Also, partial lockstep systems have become increasingly popular; these have several 'tiers' or layers to the profit allocation calculation – a lockstep portion and one or more layers of performance-related allocation, normally linked to financially-based criteria.

Even more recently there has been a trend towards the merit-based element being based both on financial *and* non-financial (judgemental) criteria, such as development of talent (recruitment, mentoring, training etc), team leadership, lock-up and stakeholder relations.

One driver for the move towards merit-based systems is the need for firms to attract young partners who are capable of delivering significant financial outputs despite their relative lack of experience. Thirty-plus years ago this would not have been the case – the winning of work was the domain of the senior partners via their reputation and connections built up over the years.

Another influence on profit-sharing systems is the recognition that partnership is no longer regarded as necessarily a long term career commitment ('job for life'), so profit-sharing arrangements need to be sufficiently attractive to retain talent that might otherwise be tempted to 'move on'. In the same way, the increasing number of female partners means that there needs to be flexibility rather than rigidity in the profit allocation systems.

The trend towards merit-based systems in professional services firms is also a response to competitive pressure for top talent from industry, where remuneration structures have always been merit-based. It is this pressure that is partly driving the recent trend towards equity share based rewards. The introduction of the ABS regulations and the resulting entrance of private equity and other non-lawyer investors will further accelerate the need for innovation and competitiveness in partner remuneration structures.

The 2007 recession/credit crunch in the UK has placed a severe strain on the profitability of many professional services firms, especially lawyers, and this has heightened the focus on individual and team performance and profitability, accelerating the move from lockstep towards at least partially merit-based systems.

The trend away from lockstep towards merit-based systems is expected to continue. In PWC's 2012 Law Firms' Survey, they comment as follows:

> *"There is a trend towards more performance-based reward systems for partners – a trend we expect to continue as the role of partners changes and as different models (including equity share based rewards) are introduced.*
> *There is an increased focus by firms for partners to set objectives and have formal performance discussions, and to link partner performance to reward. This is all driven by the ongoing pressure on profitability and the focus on how profits are shared."*

Basic requirements of any profit allocation system

It is important for any system to satisfy the following objectives:

- Each partner must be able to understand clearly in advance what is expected of them to achieve the various levels of profit allocation potentially available to them. In a simple lock step system this might just be the passage of time, but in systems with even partial merit-based elements the criteria that determine the eventual overall outcome can be multi-faceted, including financial and non-financial (judgemental) criteria in areas such as management, marketing, coaching and leadership. Partners must therefore know what is being asked of them, what good and bad performance looks like and how it impacts their remuneration.
- Performance criteria must be set at levels that are relevant to the partner and 'challenging, but achievable', if they are to have the desired motivational effect.
- Transparency: Partners must have visibility of how other partners' profit shares are calculated, and to view them as fair.
- For smaller firms there must be sufficient scope for discretion and flexibility to deal with special cases and new situations.
- The system should not be changed too often, otherwise it will lose credibility and motivational impact.

We now set out a brief summary of the various systems. These systems relate to equity partners only. We regard 'salaried partners' and 'fixed share partners' as effectively still employees; presented as 'partners' to the outside world for reasons of status.

Lockstep

Lockstep was, until relatively recently the most common profit allocation system in professional services firms, and still forms the core, or at least part of most firms' systems. In its most basic form the total profits available to equity partners are divided by the number of equity partners, and each partner receives the same amount, regardless of seniority (number of years as a partner) or individual contribution/performance. In reality, almost all lockstep systems recognise the value of seniority and there is therefore a 'probationary' period during which a new partner's share of profits gradually builds up over, say 5-10 years, until it reaches a 'plateau', at which it remains until retirement.

The simple example below portrays a 10-partner firm which generates total profits of £2.5 million. There are 5 time-related 'steps', i.e. it takes 4 completed years for a partner to get onto the top step. In this example steps are defined in terms of a number of points. In the year set out below, each point has a value of £2,907 (total profits of £2.5m divided by 860 points):

Steps	*1*	*2*	*3*	*4*	*5*	*Total*
Points per partner for step	*60*	*70*	*80*	*90*	*100*	
Number of partners on step	1	2	1	2	4	10
Total points per step	60	140	80	180	400	860
Total profits of firm						£2,500,000
Profit per partner in each step	£ 174,419	£203,488	£232,558	£261,628	£290,698	

There are variations on the above type of lockstep that distinguishes solely on seniority:

- Hybrid lockstep: These 'managed lockstep' systems include exceptions to the time-lapsed formula, including the following type of features:

    - ‘Gateways’: Stages in the lockstep where partners can move up the lockstep more rapidly than the norm, for high performers, or even be held back or moved down.
    - ‘Super-plateau’: Additional points for partners who have reached 100 points (in the above example) and are star performers. This might be used, for example to prevent them leaving.
    - Additional points for partners who take on senior management roles or other distinguishing roles.
- Lockstep plus discretionary or formula-based performance-related element: We return to this later.

The advantages of a lockstep system include the following:
- It is simple to understand and operate. There are no judgemental aspects (except with some hybrid lockstep systems). This reduces the amount of management time involved in devising and calculating the outcomes, which can be contentious in the judgemental areas.
- It encourages collaboration between partners, rather than self-serving behaviours.
- It places the firm and its clients at the centre of the whole ethos of the firm, and discourages an ethos where individual partners feel they ’own’ specific client relationships.
- It rewards seniority and the implied increasing value accruing over increasing periods of service.

The disadvantages of a lockstep system include the following:
- It does not reward high achievers
- It does not specifically deal with the issue of poor performers or shirkers.
- It can reward moderate partners more than they deserve
- It does not reward sufficiently quickly superior young partners
- It does not penalise partners who ‘cruise’ through the later years of partnership.
- If total profits stagnate, increase marginally or decline, senior partners’ profit shares are diluted in favour of younger partners who are moving up the lockstep ‘ladder’ purely due to the passage of time.

Lockstep systems tend to work better the larger the firm. For younger, smaller firms the lack of flexibility in a lockstep system tends to hamper the firm’s ability to attract and motivate the key individuals, especially if the system simultaneously dilutes senior partners.

Performance-based systems

Performance-based systems or lockstep systems that include a merit-based tier can be based on a wide range of criteria. Traditionally the criteria are financial and ‘formulaic’, and typically relate to the winning of new clients (‘rainmaking’) and billings. More recently the criteria have extended to a wider range of financial criteria and also non-financial criteria, and often include a discretionary tier. For example, Deloitte’s annual report states that partners’ remuneration is based on the following criteria:
- *Quality: Role model for the quality of professional work*
- *Talent: Contribution to mentoring, leading, recruitment, engagement, development and training.*
- *Clients: Managing a portfolio*
- *Brand and eminence: Marketing activity and stakeholder relations*
- *Revenue generation, growth and business-building: This is the traditional criteria.*
- *Financial success: Presumably this covers lock-up, possibly capital raising etc.*
- *Leadership and management: Contribution to growth through leadership and management roles, as distinct from client management roles.*

One common pre-cursor to the merit-based criteria is the preparation by each partner of an annual personal ‘Business Plan’ that sets out their plans for what they intend to achieve in each area. These personal Business Plans must, of course be consistent with the firm’s overall strategy and objectives. The partners can then be judged subsequently on relative achievement against their Plan.

The advantages of a performance-based system or lockstep system that includes a merit-based tier include the following:
- Each partner is held accountable for their financial (and, possibly non-financial) performance, and stands to be rewarded or penalised, as appropriate depending on their outcomes, regardless of seniority.
- If the performance criteria for individual partners are congruent with the firm’s overall strategy and objectives, then the sum total of all the partners’ behaviour should be in the best interests of the firm.

- The system should appeal to lateral hires and high-performing junior partners, who can see a clear link between effort and financial reward.
- Partners' attentions can be drawn to a number of aspects of their roles and responsibilities, not just the overall profit of the firm.
- Such remuneration systems are akin to those found in industry.
- To the extent there is an element if discretion in the criteria, then 'special cases' can be accommodated during, or at the end of a financial year.
- Senior partners who perform well will not be diluted by junior partners, unless they are out-performed by them, or unless the lockstep element of a multi-tiered system causes such an outcome.

The disadvantages of a performance-based system or lockstep system that includes a merit-based tier include the following:

- If the criteria are not set in ways that are congruent with the firm's overall strategy and objectives then there may be dysfunctional behaviour and a lack of collaboration.
- The management time required to devise the criteria (which can be complex), then measure it and provide feedback can be extensive.
- The judgemental aspects can cause friction or feelings of favouritism or resentment if not handled properly (see above regarding the need for clarity and visibility).
- Some formulaic systems can be manipulated by cynical partners.
- Many firms' businesses are dynamic and the relevant criteria can change quite significantly both year on year, and even within a financial year. Retaining sufficient flexibility can therefore be a challenge. Also, in light of all the recent external challenges and changes to market conditions (credit crunch, ABS, Eurozone problems etc), the setting of performance criteria each year must be underpinned by a similarly dynamic culture and attitude in the firm.

Many of these problems are more relevant to larger firms and are easier to deal with in relatively small or young firms.

'Base Salary' tier of profit allocation

Aside from lockstep and performance criteria, many firms have a first tier of profit allocation that is intended to represent the 'market rate salary' for each partner. For example if a law firm has an experienced litigation partner whose 'market rate salary' (i.e. a cautious/low estimate of what they could command if they went elsewhere) is £175,000 and, elsewhere in the firm a junior family law partner whose equivalent 'market rate salary' is £125,000, then the first tier of the firm's profit allocation might comprise such amounts, with the rest of the profits being allocated on, perhaps a mix of lockstep and performance criteria. This Base Salary is obviously only payable if the firm generates the necessary level of overall profits to cover the Base Salary tier of profits.

One of the benefits of having such a first tier is that it emphasises the nature of being a partner; i.e. wearing two hats:
a) working **in** the business, like an **employee,** capable of earning a salary working elsewhere (without the risks of joint & several liability), plus;
b) being an owner of the business, participating in profits over and above the payment of the partners' 'salaries', like a **shareholder or investor**.

Clearly, the introduction of a tier of Base Salaries opens up scope for debate and resentment, as is the case with setting performance criteria.

Turning back to the worked examples above, the following is an illustration of how the 10-partner firm's profits would be allocated if there were three tiers:

- Base salary tier
- Lockstep tier, accounting for 50% of the firm's remaining profits;
- Performance-based tier accounting for 50% of the firm's remaining profits, comprising both financial criteria and non-financial judgemental criteria.

The lockstep tier uses the same steps as in the previous example, pro-rata. The performance tiers involve 5 levels of performance (compared to targets or objectives set in advance):

P1	Poor	10-21 points
P2	Below satisfactory	22-41 points
P3	Satisfactory	42-61 points
P4	Above satisfactory	62-87 points
P5	Excellent	88-100 points

The overall result for our illustrative firm's £2.5 million profits is as follows:

Partner	Base salary	Lockstep (50%)			Merit-based (50%)			Total £
		Step	Points	Profit share (£)	Points	Level (P)	Profit share (£)	
A	120,000	5	100	90,233	60	3	64,667	274,899
B	110,000	5	100	90,233	55	3	64,667	264,899
C	100,000	5	100	90,233	40	2	43,111	233,344
D	110,000	5	100	90,233	90	5	107,778	308,010
E	92,000	4	90	81,209	65	4	86,222	259,432
F	95,000	4	90	81,209	60	3	64,667	240,876
G	88,000	3	80	72,186	63	4	86,222	246,408
H	78,000	2	70	63,163	65	4	86,222	227,385
I	80,000	2	70	63,163	80	4	86,222	229,385
J	75,000	1	60	54,140	75	4	86,222	215,362
	£948,000		860	£776,000	653	36	£776,000	£2,500,000

Profit per point	£902	Profit per level	£21,556
Total profit for tier	£776,000	Total profit for tier	£776,000

Note, for example that partner 'I' is only on lockstep 2 but performed well ("Above Satisfactory") and earns £229,385; only slightly less than partner 'C' who is on lockstep 5, earns £20,000 more Base Salary but performed "Below Satisfactory" and earned £233,344. In the previous worked example for this firm (lockstep-only) partner 'I' earned £203,448 and partner 'C' earned £290,698.

Obviously different mixes of lockstep vs. merit based proportions could be used, and would affect the relative outcomes for individual partners.

With reference to the problem highlighted previously regarding dilution of senior partners' profit shares when there are marginally increasing, stagnant or declining profits while junior partners move up the lockstep, the multi-tiered structure with merit-based elements should prevent such an outcome because, by definition, if profits have not increased significantly then one or more partners' personal 'Business Plans' must not have been executed effectively, so they would be 'penalised' under the merit-based tier and a decently-performing senior partner would thereby not suffer unfair dilution.

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