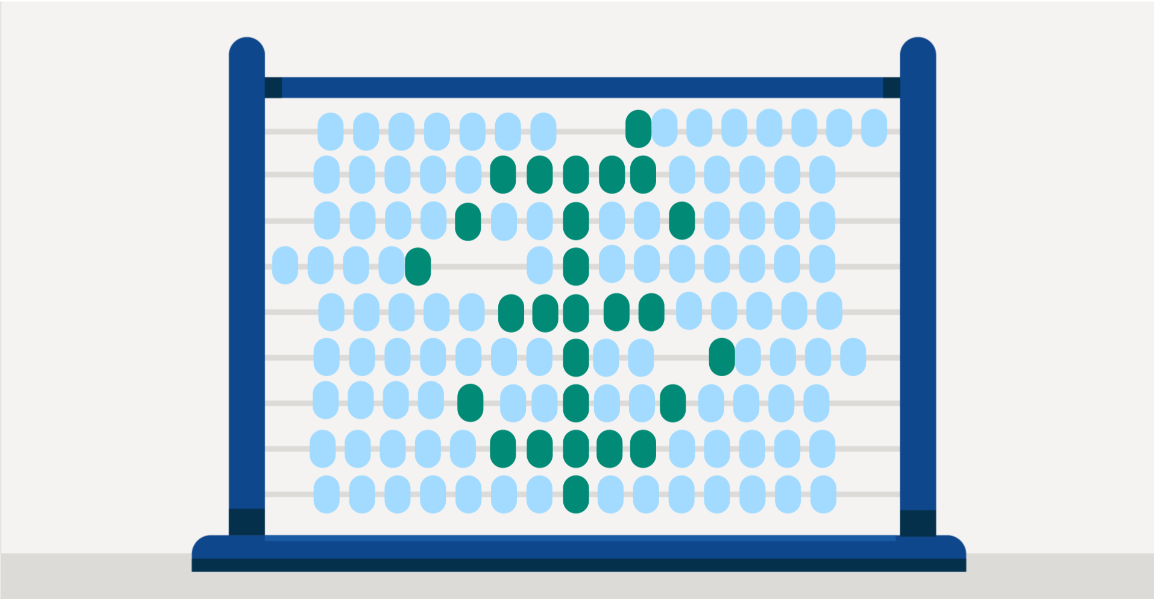

Law Firm Profit Sharing Formulas and Compensation Models

Written by Megan Smith

Law firm profit sharing formulas are a complex and often controversial topic. In fact, any discussion of law firm compensation models can turn contentious. Many legal professionals have their own opinions about “the best way” to do things, based on their own experiences.

In addition, many firms operate using traditional, origination-based compensation systems and profit sharing formulas. These methods can cause problems such as burnout. Not to mention creating a toxic work environment. If employees feel undervalued and underpaid the risk for turnover is substantial.

The truth is, there is no single “best” formula that will work for every firm. Some formulas are purely subjective, some are structured, but most are a mix of the two. In this post, we’ll discuss profit sharing formulas in detail, and alternatives to the traditional (and outdated) compensation models.

How do law firms share profits?

Law firm profit sharing means that the firm’s employees receive a percentage (or share) of the profits based on quarterly or annual earnings. In law firms, profits are most often shared among the law firm’s partners.

Traditional law firm profit sharing formulas

Let’s look at an example. If there are 10 equity partners involved in a firm, and the firm made $1 million in net profit, the following would be the calculation per partner:

$1,000,000 net profit / 10 equity partners = $100,000 profit per partner

However, this only works if the partnership agreement between the partners divides profit equally. Partnership agreements often contain a different division formula for dividing up profits.

For example, a firm with 10 equity partners may have two **senior** equity partners that get a 2x share of profit. The calculation would then be:

- $1,000,000 net profit / 8 equity partners + 2 senior equity partners = $83,333 profit per partner and $166,666 profit per senior partner

Learn more about how much partners make at law firms.

It all comes down to accounting

Firms will handle the accounting differently, but most profit distributions are paid from expected profits, either on a monthly or quarterly basis. As a result, most firms also make quarterly tax payments on their expected annual income.

It's common for firms to use a fiscal calendar that aligns with the actual calendar. The accounting records Day 1 for the year as Jan. 1., and it ends on Dec. 31. That means firms at the beginning of the year may not have a lot of expected profits, but a partner will still have to make quarterly tax payments on March 15 based on their estimated income for the whole year.

Some partnership agreements will also have a minimum distribution amount as a part of the contract. A firm might agree to pay partners $10k a month, regardless of the firm's current profitability. These payments are advances on future profits. This would subtract them from the PPP they owe to the partner at the end of the year.

A firm might have to incur debt to pay minimum distribution amounts, so it can be risky to agree to either too high or too frequent an advance.

How do you calculate profits per partner?

Profits per partner (PPP) calculations can be simple. Take the net profits of the law firm (revenue minus expenses) and divide them by the number of equity partners.

Challenges with law firm profit sharing formulas

Traditional law firm profit sharing formulas have the tendency to have negative effects on your employees:

- **Burnout**. Because this model focuses on billable hours and bringing in new business, employees are pressed to work incredibly long hours in order to reach goals. Many firms set annual hourly billing targets for non-profit sharing lawyers. Meaning they only receive bonuses, or in some cases larger bonuses, if targets are met. Clio's Legal Trends Report found that 75% of lawyers frequently work outside of regular business hours. Additionally, the report found that lawyers work, on average, 140 unplanned hours a year. These statistics prove that lawyers are willing to do whatever it takes in order to meet hourly billing targets, even if it leads to complete exhaustion and burnout.

- **Toxic work environment**. A compensation system that is purely revenue-based can cause an overly competitive work environment. This can have negative effects on your employees' mental health and work-life balance. It also only recognizes and rewards the individual who accomplishes these items—which discourages collaboration and creates silos within your organization.

As a result, these effects bleed into the overall performance of your law firm:

Profit sharing prioritizes getting clients over providing a client-centered experience.

Billable hours and bringing on new clients are vital for a law firm's success. However, only focusing on these two items can hinder the performance of your firm. Many other aspects contribute to a well-rounded and successful law firm, one of which is creating client-centered experiences—which is impossible to accomplish if your firm is strictly focused on bringing in new clients. Building client relationships and experiences that exceed expectations are essential to retaining lifelong clients, which in the long-term aids in revenue and business growth.

Profit sharing focuses on money instead of the firm's mission and values

Similar to the above, there is more to your firm than profits. By only rewarding employees who bring on new clients and rack up billable hours, you're not encouraging them to uphold and promote any of your firm's values and mission statement.

This can manifest itself into the way employees treat clients, each other, and conduct themselves in professional settings such as networking events.

Non-lawyer staff are left behind

Traditional models reward attorneys that bring in the most work. This fails to recognize non-attorney employees who have helped the firm meet its goals. Additionally, this might cause members of your firm to feel undervalued. Resulting in a high turnover rate.

Alternatives to traditional law firm profit sharing formulas

Here are a few ways you can avoid the downfalls of traditional profit sharing:

Tie compensation to your law firm's goals, mission, and values

Crafting a mission and stating your values and goals is an essential part of your firm's business strategy. If you've already documented your mission and values—you're off to a great start! But they must be living throughout your organization.

Ensure that every staff member—lawyers and non-lawyers—understands how their role impacts these goals. You can do this by reviewing how their day-to-day responsibilities relate to the firm's overall mission and values.

From there, you can align bonuses with your firm's values, goals, and mission. Again, this motivates each team member to uphold these items and lends a hand in creating a successful law firm. Furthermore, include these KPIs (key performance indicators) into your compensation model for each employee.

Consider non-partner and non-lawyer staff

The Model Rules of Professional Conduct state that lawyers cannot share legal fees. However, it is essential to encourage non-partner and non-lawyer staff to do their best in their roles to contribute to impacting your firm's business strategy.

Provide fair, market-value salaries and bonuses.

Offering fair, market-value salaries to employees will ensure they feel valued and motivated to accomplish the duties required of their position. Therefore, when researching what fair compensation would be, consider the following:

- Position
- Industry/practice law area
- Location

Reward staff for providing a client-centered experience

Providing a client-centered experience means truly putting yourself in your client's shoes and looking at the experience of going through a legal matter from their perspective—and creating a positive, memorable experience for clients is efficient for your firm. This does not mean sacrificing profitability—just the opposite, in fact. Providing a client-centered experience encourages repeat business, increased referrals, and can boost awareness of your firm.

One way to encourage employees to provide client-centered experiences is by linking client reviews to bonus calculations. Measure team members that create documented positive client experiences, like high Net Promoter Scores, referred clients, and positive public reviews. High-scoring employees can have those contributions recognized by the firm with increases in their bonuses.

Clio is extremely passionate about creating client-centered experiences in law—in fact, our CEO, Jack Newton, wrote an entire book on it. You can order a copy here. Or, if you prefer podcasts, the second season of our Matters podcast is focused on creating client-centered experiences—check it out!

Compensation is part of your firm's strategic plan

Adding anything new to the way your business operates can be difficult, and takes time. Profit sharing models are no exception. The difficulty only increases when there are multiple partners making the decisions. To prepare for these conversations, and to start implementing these items in your firm's strategic plan, remember:

- The traditional profit sharing formula is detrimental to your firm. It typically leads to a higher likelihood of burnout, hyper-competitiveness, and poor customer service. These are not qualities of a successful law firm, after all.

- Tying compensation and bonuses to your mission, your values, and your goals is a great way to ensure your employees feel valued.

- Providing a profit sharing model that embodies a "client-centered experience" increases profits and delights your clients—without compromising efficiency.

Note: The information in this article applies only to US practices. This post is provided for informational purposes only. It does not constitute legal, business, or accounting advice.

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About Clio

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