

Legal Week

Financial Management: A step too far

In times of trouble, partners look to the firm's lockstep as something of a rock — the profit expectations of partners are, after all, the bottom line in a firm. But as firms have expanded their partnerships so much, especially overseas, the purest form of the lockstep has gone out of fashion. The traditional lockstep, which rewards long service and firm loyalty, has proved itself unsuited to the task of reeling in high profile, high earning US or Italian partners who would never contemplate a pay cut, never mind going in at the bottom of the lockstep and working their way up incrementally.

Indeed, tinkering with the lockstep has become almost essential to bring in or retain big names as well as to the task of rewarding partner performance — Norton Rose, Clifford Chance and Ashurst have all made significant modifications to their locksteps in the last few years. So is this the end of the line for the pure lockstep? And in abandoning it, are firms breaking down loyalty and opening themselves up to a wider risk that the lockstep was designed to avoid?

Since the likes of the erstwhile Freshfields and Linklaters were founded in the 18th and 19th centuries, most partnership agreements have periodically been re-written after a spate of blood-letting and partner disgruntlement over the distribution of profits — arguing over the spoils is definitely nothing new.

But the firms of the 1700s did not have to cope with the management demands of today's 500-partner firms. The cluster of top-20 City firms has evolved a mixed system of merit and lockstep to deal with the different and complicated demands of their commonly worldwide partnerships.

A glance at London's magic circle firms shows the resolutely City-oriented Slaughter and May to be the exception to the modified lockstep rule. It employs a traditional lockstep to remunerate partners, a system that is generally held to work best in firms that have the highest level of self-discipline, to minimise the risk of carrying an under-performing partner. The reputation of Slaughters' loyal partnership certainly suggests a match between the lockstep stereotype and lockstep reality.

Indeed, Colin Ives, professional practices partner at Smith & Williamson, says that, understandably, choosing a system of remuneration comes down to culture. "If a firm is operating a pure lockstep, is it the right culture for a firm?" he says. "It produces an extremely collegiate team, but can it put the brakes on aggressively expanding into new jurisdictions?"

Slaughters, with its core of only five overseas offices, has neatly sidestepped the lockstep issue through its inherent conservatism.

But the Achilles' heel of many of the English firms that have gone global is undoubtedly partner compensation, and the sometimes-heavy management that goes with running a lockstep. Domestic firms in key jurisdictions such as the US and Italy have always paid their top partners significantly more than their counterparts in London. But offering partners the same compensation as in lower cost jurisdictions causes resentment among partners in higher billing jurisdictions. So would a pure merit-based system fare better for the global firm? Magic circle firms Clifford Chance (CC) and Allen & Overy have both found themselves in the headlines for luring well-known partners in the US with hefty golden handshakes in the lockstep.

CC, in particular, has found that its decision to bring in certain partners above the lockstep in the US caused it major headaches. When the winding down of CC's Los Angeles and San Francisco offices becomes complete by the end of July this year, the firm will have lost almost 40 partners since January 2003, although it admittedly still has more than 100 partners stateside — the most of any magic circle firm. The losses have come despite CC last year controversially voting in a system providing for the allocation of additional equity points to help attract and retain key US partners — a system that at least one US CC partner privately admits caused considerable ill-feeling in the wider firm.

The compensation agreement allowed for up to 12 'super-pointer' US partners to be paid up to 50% above the top of the lockstep. At the time, CC stressed the importance of the flexibility this system of compensation allowed to build a global practice. But key US partners, including Washington DC partner and global head of antitrust Steven Newborn, have quit CC to return to US firms — Weil Gotshal & Manges, in Newborn's case — despite their above-lockstep pay packets.

Managing a globally ambitious firm is undoubtedly an unenviable task when it comes to distributing the spoils and justifying a multi-million pound investment in a new US partner can take time and patience.

Colin Ives says that altering the lockstep to accommodate such partners can be very risky. "You really have to be very clear about what you are doing and the motivation behind it, and explain it to the partnership as a whole," he says.

In the US, the pure lockstep is adopted sparingly, but to great effect. The traditional lockstep is used much less than it was a decade ago, after the salary wars of the late 1990s and early 2000s saw the demise of associate lockstep systems at major firms including Piper Rudnick, and West Coast giant Morrison & Foerster. Tempting associates with large salaries meant breaking the traditional

lockstep at this level, prompting concern about the associates' lockstep plan negatively affecting partner profits.

At partner level, the argument goes that the lockstep in its traditional form is a mixture of clan and bureaucratic control, and that US firms that employ a lockstep lean heavily towards the clan theory. Most famous for its lockstep is New York's Cravath Swaine & Moore, one of the most profitable firms in the US.

Those in the firm thought to be unsuitable for partnership are pressured to leave early on, making it a case of fitting in or getting out. According to Cravath, a third of all associates leave within three years, with a third more leaving by the end of their fifth year.

By the time the average eight years to make partner is up, a majority of those that made the step up to associate will have left — a fairly brutal filter that makes sure there is no dead wood in the 80-strong Cravath partnership.

In line with the lockstep firm's conservative recruitment mantra, Cravath, like Slaughter and May, has a policy of not making lateral hires. This in turn makes it easier for a lockstep to function as all partners enter at the same level, and everyone knows that each partner is in it for the long term.

In fact, a handful of highly profitable, successful firms have pure locksteps that go against the US 'eat what you kill' trend. Cleary Gottlieb Steen & Hamilton, Davis Polk & Wardwell, Wachtell Lipton Rosen & Katz, as well as Cravath, all boast collegiate cultures that they are proud of.

English firms, however, seem less keen to promote the lockstep as a source of collegiality and equality, and more keen on tinkering with it as a management tool. One of the most recent examples of this is Ashurst, which has moved partners down the lockstep in a bid to raise the performance bar after profits dropped. Like fellow City firm Norton Rose, Ashurst was requested to leave two gateways into the partnership; partners who meet performance expectations at various stages can move up through these gateways. Crucially, however, under-performing partners can also move back down through these gateways.

For its part, fellow City firm Norton Rose has initiated a three-tier lockstep system that has introduced junior equity partners for the first time, and split the equity into three performance-based levels.

While few managers or ambitious lawyers would deny that an element of performance-based pay is desirable, is a lockstep still a lockstep when it has been altered to this extent?

Tim Emmerson, a London-based Milbank Tweed Hadley & McCloy corporate partner, says **offering financial incentives to a departing partner to stay can be very disruptive.**

"It can be dangerous to mess around with your lockstep as it creates bad feeling and resentment with the other partners, who feel blackmailed," he says.

In emerging jurisdictions such as China, most notably Shanghai, none of the locally-founded firms has adopted a pure lockstep. In fact, seniority is rarely an issue among the Shanghai firms that surged onto the international scene so quickly. Instead, these firms have gone for the 'eat what you kill' system. With their market growing so quickly, partners would never have gone for the slow-drip pure lockstep. And with the body of Chinese lawyers having grown so quickly, the points of reference used to recruit like-minded lawyers (legal education, past experience) are not there.

Just as Cravath switched from a merit-based to a lockstep system back in the 1960s, some firms in Europe are following suit as they make the transition from single-partner practices to larger commercial structures. Germany's largest independent firm Haarmann Hemmelrath & Partner opted to switch to a modified lockstep system earlier this year. The changes meant all the firm's partners — except those in the most senior tier, who still earn performance-related payments — switched to a lockstep system.

Unlike with the magic circle firms, the relative youth of continental Europe's biggest firms means the sole-practitioner mentality is still a part of the partnership of firms from Spain to Poland. Changing this mentality to allow a lockstep to function properly will take a long time. But it is happening, as the changes at Haarmann Hemmelrath show. Portugal's Vieira de Almeida took a huge step last year in enlarging its partnership and bringing in a lockstep mechanism, as did the newly-merged Morais Leitao Galvao Teles Soares da Silva & Associados.

Both are examples of firms established in the past 50 years that have recently had to bridge the generation gap and set up a formal structure in the firm that will last. Meritocracies can be very divisive, and the second generation partners at these firms have opted for partner compensation systems that will avoid arguing over the spoils.

None of these firms has opted for the pure lockstep however — partner sensitivities and seniority mean that a modified lockstep has proved the model of choice. Firms' compensation of partners varies as wildly as the pay scale of solicitors across the country. As in the wider business community, rewards are less about time served than how time at a firm is spent. The multicultural mixes among the global firms means the strict rule of seniority and clan just do not work if a firm is to attract the best global talent.

So the modified lockstep is now the undisputed model of choice; firms have altered the system to accommodate big lateral hires, and introduce a thread of performance-related pay to encourage younger partners at the bottom of the lockstep. And for a very few firms on both sides of the Atlantic, the traditional lockstep has endured with impressive results.

As English firms have found to their cost, lockstep goes deeper than the number of zeros in a salary: reconciling different cultures in

a firm is a whole new ball game.

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Source: Legal Week

Start Date: 01/07/2004 00:00

End Date: 08/07/2004 00:00