Pay Proportional to Performance™

By James D. Cotterman

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Getting pay decisions done well is rarely an easy task. There are competing interests between those lawyers who primarily acquire clients and those who focus on practicing law – setting up the age-old debate regarding the relative value of each. Moreover, those competing interests appear across a broad profitability spectrum.

Unfortunately, the challenges increase when a law firm has either very little or a great deal of money to distribute. At the low end of profitability, there are competing needs of collegiality and a sense of partnership that suggest a flattening of the pay range, set against the risk of competitor poaching of high-performers that may necessitate a broader range of pay. At the upper end of profitability, the human emotion – greed – tends to display its unpleasantness.

There are also lively and ongoing debates about the appropriateness of nearly every facet of a compensation program:

a. The decision perspective: Should performance be evaluated prospectively, retrospectively or using a combination of both?

b. The type of compensation system: Formulaic, subjective, lockstep or some combination?

c. The process: What is the right amount and type of input and feedback?

d. Transparency: Should the compensation system be open, closed or a hybrid?

e. Who makes the decisions: A managing partner, various committees, or a committee of the whole?

f. The Compensation Committee: How should it be constituted and chartered?

Yet none of this really matters except in how each facet supports consistently well-made compensation decisions. We can probably all think of a number of law firms (or any other organization for that matter) that achieves great success and some measure of harmony with each of the variables mentioned above and any of the possible permutations. Likewise, we can also point to where each has gone very wrong and failed. If there were truly "one right way" to do this, a profession as learned and well-

read as law would have discovered it. There is no one right approach, which is why advising firms in this area is an interesting and challenging career.

A Fundamental Principle

There is a reliable foundation from which one can build a well-functioning compensation program. It is a particular philosophy of compensation decision-making – a compensation principle – that I call ***Pay Proportional to Performance™.*** Two research studies support this notion, the first study by David Maister and the second by Jim Collins.

David Maister, in his book, *Practice What You Preach*, states that, “Those who contribute the most to the overall success of the office are the most highly rewarded. Notice that this does not suggest what the pay scheme should be. The determining factor is just whether the people think it rewards the right people” (p. 50).

Jim Collins, in his book, *Good to Great*, similarly reports, “The evidence simply does not support the idea that the specific structure of executive compensation acts as a key lever in taking a company from good to great” (p. 49). He goes on to say, “The purpose of a compensation system should not be to get the right behaviors from the wrong people, but to get the right people on the bus in the first place, and to keep them there” (p. 50).

As these two studies showed, the method of compensation is largely irrelevant as a causal factor for high and sustained performance. What matters are good decisions from respected leaders who earn trust by adhering to the organization’s values and principles.

Key Structural Elements

On top of this ***Pay Proportional to Performance™*** foundation are various key structural elements that frame the compensation decisions. These include market competition, internal rationality, strategic initiatives and culture. Let us take each in turn.

> Market Competition: We have a free market where lawyers may move from firm to firm, go in-house, or even change professions. Pay decisions are rarely the primary determinative factor in such moves, but they often “tip the scale” when combined with other factors. Moreover, pay can become a primary factor if the market differential is large enough for a long enough period. A firm with below market profits faces a very definite risk of losing talented lawyers. Compensation decision-makers must consider this.

> Internal Rationality: The pay decisions should reflect merit, looking at a broad array of efforts – economic and non-economic – that an individual contributes to a firm’s success. However, do not forget the irrefutable underlying economic principle in professional services that there must be a baseline expectation of good results and fully utilized timekeepers at appropriate price points to ensure a healthy and profitable firm.

Strategic Initiatives: Most firms undertake long-term initiatives designed to improve the firm in one way or another. Implementation of such initiatives requires individuals to invest time, often beyond a single decision cycle. In these instances, leadership has the opportunity to demonstrate that what they say is important, really is important. Pay decisions are the proverbial "walk to the talk" opportunities. Do this right and firm leadership earns credibility and trust. Get it wrong and you not only risk losing that trust, but the partners' actions may wander between what you say is important and what you demonstrate is important.

Culture: The shared attitudes and values that define the environment of a firm vary in both importance and style. If they are important, then the compensation program should recognize how well individuals support their stated environment. Again, there is the "walk to the talk" opportunity to gain or erode trust and credibility.

Performance Assessment

Over the years, the legal marketplace has changed, law firms have evolved, as have the methods to manage them and pay their partners. In a 1993 Altman Weil survey on law firm compensation methodology, law firms were almost evenly divided on prospective, retrospective, or combined approaches to when the compensation decision is made. Fifteen years later, in 2008, a retrospective philosophy prevailed in 41% of the systems, while 35% adopted a mixed (prospective and retrospective) philosophy. The clear loser over time has been the purely prospective approach. This reflects a market-driven need to recognize individual performance more quickly in order to attract and retain people.

Yet, over that 15 year period, the two most important partner compensation criteria in law firms remained the same: 1) the ability to acquire, maintain and grow client representation (all elements of origination); and 2) to be personally productive as measured by fees collected as a working lawyer. This is consistent with the inescapable truth that successful law firms have consistently high and profitable utilization across all timekeepers. Further, it is imperative that partners possess a keen and well-developed ability to attract profitable business opportunities consistent with the firm's strategic vision.

Rank order of these broad attributes can be broken down as follows. First are those lawyers who do it all exceedingly well. Next are those lawyers who are great at client acquisition – creating initial relationship and opportunity to get work. Following closely after are those lawyers who are great at minding the existing relationships (retention and growth). It is exceedingly rare for lawyers to be in these groups without also being productive individual practitioners. Finally are those lawyers who are not relationship oriented, but are gifted practitioners. Listing them in this order roughly reflects the scarcity of each. At the top are the fewest in number, with each additional group increasing in size as we work our way through the list. This is not to say that those at the

end of the list are not valuable. It is a matter of proportional value and there can be overlap in value among the groups.

Client acquisition is first on the list for a reason. Law firms that do not meaningfully recognize client acquisition, retention and growth often transfer that recognition out of necessity or cultural orientation to the working lawyers (using the personal productivity metric). Those firms are more likely to struggle with profitability and growth, although this is not always the case.

Recognizing client acquisition, retention and growth is important in compensation decisions, yet many firms do not formally track work as it comes in the door. This often leaves compensation committees to sort out a realistic snapshot of how and why clients come, stay and give more business to the firm. Moreover, this task only gets more difficult as firms grow and the nature of the client relationships expand across time zones/offices, client business divisions and firm practice groups.

The best approaches to recognizing origination usually incorporate some or all of the following attributes.

> Shared Credits: Working together to pitch your firm's skills is a good thing. When those efforts result in success, recognize the entire team with origination credit. Go back to the ***Pay Proportional to Performance™*** concept. Allocate the credits using the proportionality of effort and contribution to the sales effort, erring on the side of generosity. When the efforts do not land additional work, recognition for the efforts can come in the intangibles of marketing and firm promotion.
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> Broad Definition of Origination: Some firms evaluate client acquisition, retention and growth with a single very narrowly defined metric; others blend two or more metrics together, creating a broader definition of origination. The debate continues about how and why a new client gives the firm its business. Frequently, the discussion now focuses on who should receive credit for long-term clients as the boomer generation lawyers prepare to retire and how to handle transition from one generation to the next. Understanding that this unique ability to acquire, retain and grow clients presents itself in a variety of ways may lead a firm to a better set of decisions.
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> Credit Duration: At the client level, credits should last for a period of maybe three to five years, then be phased down or reallocated based on the current contributions to the clients' retention and growth. Often these efforts focus on relationships and strategic guidance as opposed to specific case management. At the matter level, credits naturally last the duration of the matter. The decision to open new matters or not should not be driven by reluctance to honestly assess who should get credit in the current situation. Matter level credits generally do not require reallocation.

Beyond primary economic contributions, there is a significant amount of talk about the importance of collaborative behaviors in law firms. Yet a 2009 ALM study indicated that individual performance drives 64% of compensation decision-making in law firms. The second greatest driver is overall firm performance at 27% (probably due to its effect on the size of the distribution pool at year-end). That leaves less than 10% weighting to subjective/qualitative areas such as teamwork in practices, departments and offices. Clearly, the "walk" of compensation decisions is not proportionate to the "talk."

To obtain proper proportionality in compensation decisions, subjectivity is likely going to take on greater weight in the final decision. However, subjectivity in this area generates the kind of polarizing passions more typically reserved for political and religious discussions. Some firms embrace a qualitative approach, while others flatly reject such notions. Nearly one-third of the respondents in a recent study indicated that no portion of owner compensation is subjective. In addition, just over one-third of respondents in the same study indicated that 76% to 100% of owner compensation is subjective. There will likely be significant change in this area as law firms and the markets they serve evolve over the next decade. Alternative fee arrangements and legal project management will evolve and clients are likely to continue to pursue different means to obtain its legal services.

***Pay Proportional to Performance*™** is an important principle underlying good compensation decisions. Individual firms will select different compensable criteria and weigh them according to their specific views. Good judgment will bring the principle alive.

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