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Why Do We Have Compensation Programs?

By James D. Cotterman

The phone rings. The voice on the other end of the line introduces herself as the new managing partner of a century old law firm. She got the job two weeks ago, during a generational transition over concerns regarding management and direction. Her firm is mid-sized, does specialized work and is located in a mid-sized city in the central part of the US. The "old guard" acting as benevolent dictators led a tight, closed law firm. After some key departures, they agreed to a transition, but are still active and involved. Their "formula" is not working, particularly once a partner retires. And they need help putting something different in place.

And this is often how it begins: someone seeking a different program, structure, or process to decide compensation. What changes are appropriate? First look at the reason compensation programs exist in the first place.

WHY DO COMP PROGRAMS EXIST?

They exist to make consistently good compensation decisions. It may sound self-evident, but it is a critical truth that is often overlooked. The compensation program is an aid, tool or framework that facilitates decision-making. Decision quality is assessed first. If the decisions pass muster, then the structure and process are examined to assure that the decision quality is likely to be sustained and there is good communication between decision makers and the partners. If the decisions do not pass muster, then the structure and process are examined to improve decision quality and understanding.

Making consistently good compensation decisions has become fundamentally harder. As the profession ages its boomer generation into retirement or a twilight zone of semi-activity, it simultaneously confronts fundamental shifts in client engagement as well as competitive pressures from technology and even more specialized providers of segments of services once handled exclusively by the firm. The business model of the profession is broader and more diverse than ever. What was once a profession where top line analysis was sufficient has become much more stratified, requiring more and different metrics and a bottom line assessment. Where growth was historically achieved by grooming associates coming out of law school, it is now primarily achieved from laterals bringing clients to their new firm. Lateral compensation premiums stress internal pay equity considerations within law firms. The environment in which compensation decisions are made is more complex and more difficult than ever. "*Fasten your seat belts; it's going to be a bumpy night*[1]" may best describe the journey that lies ahead.

Two examples follow illustrating how different firms have different priorities and critical success factors that affect their approach to compensation decisions. This first is metric driven, while the second is culture driven.

EXAMPLE: A METRIC-DRIVEN PROGRAM

A law firm was wrestling with a compensation program that had been around for just under two decades. The program was an objective, metric driven approach which they had modified several times over the intervening years. Each tweak addressed a particular concern at the time, but with each tweak the decision quality decreased and the complexity of the program increased.

After review, our recommendations were short and simple. First, use the original program – it yielded good results and was easy to understand and apply. Second, do not tweak the program on your own without assessing the program against broader principles, which we discuss below.

EXAMPLE: A CULTURE-DRIVEN PROGRAM

In another situation, an extremely stable law firm had a largely subjective compensation program. They had metrics – all of the typical accounting system data. Those metrics explained much of the variability of the compensation decisions. But there was an atypically large variability in compensation decisions that could not be explained by the financial metrics. The key to understanding this firm was in its culture. This firm's culture was a true ethos of the partners. They believed in individual performance differences, but only up to a point.

Our assessment was that their decisions fit their firm, even if they departed from profession norms. Our advice was focused on communication – individual feedback to each partner and group discussions about how the committee functioned and members worked through the data and assessments of the partners.

BEST PRACTICE GUIDELINES

I can anticipate your question, "Is he going to be happy if we use a Ouija board as long as it gives good results?" I would strongly question its ability to consistently deliver good decisions and the partners' comfort with the results – irrespective of the decisions analytical quality.

So are there any guidelines regarding compensation process and structure that can be applied? There are, and those guidelines are best practices in partner compensation. Often, readers are surprised that the best practices do not identify a specific structure or approach. Similarly situated law firms can have different compensation programs that each work well at their respective firms. Likewise, the same compensation program can work well at one firm and not at another. Here are the best practices we use to evaluate partner compensation decisions.

1. **Internal consistency** — Pay Proportional to Performance® — Would an independent observer looking at the basket of contributions, their relative importance, individuals' total contributions and the corresponding pay decisions reasonably conclude that those who contributed more to the organization's success were remunerated proportionally more than others?
2. **Strategy linkage** — Recognizing smart, informed risk-taking efforts and results appropriately — Is the message of what is important from a strategic business perspective clear and aligned with how pay is determined? Are smart risks rewarded, even if unsuccessful? Are efforts and results each appropriately considered?
3. **Cultural alignment** — Supporting the group's agreed-upon values and desired work environment — Are firm values and the desired work environment clearly communicated and embraced? Will a person's behavior affect compensation in an appropriate and meaningful way?
4. **External competitiveness** — Effectively managing departure risk created by under-market compensation — Are the pay decisions competitive with what is available in the market or at least what is available in other similarly situated organizations? If this cannot be accomplished across all partners, is it at least being done effectively to manage departure risk of stars and rising stars?

SUPPORTING RESEARCH

At Altman Weil, we have developed metrics and models to examine what influences compensation decisions, their consistency and the level of risk they represent to the firm. The development of these assessment tools came out of our own research and the research of others.

Examining methodology

In 1991 Ward Bower authored a white paper on compensation entitled "*Can a Partner's Value Be Measured?*" That began an examination into compensation from a structure and process perspective. In 1993, Altman Weil initiated the first survey on law firm compensation methodology – a review of how such decisions are made, by whom and using what factors. Then, 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:

- The ability to procure, maintain and grow client representation (all elements of origination); and
- 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 procurement – creating initial relationship and opportunity to get work. Following closely after are those lawyers who are great at minding the existing relationships (retention and proliferation/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.

A focus on people

In 2001 two excellent research studies were published. One dealt with professional services practices (*Practice What You Preach*, by David Maister[2]), the other with large public corporations (*Good to Great*, by Jim Collins[3]). Each examined high-performing organizations and concluded that the method of compensation is largely irrelevant as a causal factor for high and sustained performance.

As David Maister put it, "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." He also observes, "The most striking finding is that the most financially successful offices did better at *virtually everything*."

Jim Collins similarly reports, "We found no systematic pattern linking executive compensation to the process of going from good to great. 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." 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." And finally, "Those who build great companies understand that the ultimate throttle on growth for any great company is not markets, or technology, or competition, or products. It is one thing above all others: the ability to get and keep enough of the right people."

Again the quality of the decisions being made about people — hiring them in the first place, the careers they follow, and the recognition decisions about their performance — are what the firm must get right. Any specific compensation system may or may not be the right structure for an organization to achieve that end.

EFFECTIVE COMMUNICATION

In addition, effective communication regarding performance and compensation and how both relate to strategy and culture is a best practice. It is simply not sufficient to believe that compensation decisions will stand on their own merit and be interpreted by the recipients in the same way as firm leaders intended absent candid and constructive dialogue. We have tested for this and found even positive compensation decisions may not be interpreted correctly by the recipient, particularly if the individual's expectations differed from the result. We assess communication against the following questions:

- Are the communications candid and constructive?

- Are they bi-directional? The partner compensation process tends to be high touch, with partners providing input in advance of decisions and receiving feedback after decisions.
- During feedback, do you discuss how a decision was reached and demonstrate that you carefully considered partners' written materials and actively listened during their interviews? Do you tie together this year's decision and how to improve next year with their roles in advancing the firm's strategic interests and culture? Are the right people involved in that conversation? Many firms fail here.

EQUITY IN COMPENSATION DECISIONS

The equity theory in compensation states that compensation is an exchange of labor for pay and that there is an appropriate pay range for every job. This theory explains why underperforming partners are not rehabilitated by reductions in compensation. The underperforming partner, working under the equity theory, reduces performance to a level s/he believes appropriate to the reduced pay (the partner did not believe performance was low relative to pay before the reduction). If a compensation reduction is necessary it should be made to recognize internal equity with others, not to correct the behavior or improve performance. That must be handled differently.

An equitable decision does not necessarily equate to a single, objectively "right" or "correct" decision for each individual. Many businesses look at the market and benchmark the range between the lower quartile (the point below which 25% of the job holders fall) and the upper quartile (the point above which 25% of the job holders fall) – otherwise known as the inter-quartile range or middle 50% – to gauge the appropriate market pay for a position.

Compensation decision-making in law firms, even in formula firms, is not that precise, nor will it convince everyone of the wisdom and fairness of the amount they receive. It is better to strive for a significant majority to strongly agree that, on the whole, those whose labor (efforts and results) contributes more long-term value to the organization receive higher compensation (wages and benefits). This internal consistency observed as a comparison of one's own contributions and pay relative to those of others is the essence of Pay Proportional to Performance®. It is also one of the strongly positive attributes of open compensation programs. It provides transparency and reference points for all to observe.

The fundamental components of "contribution" for law firm partners are personal productivity *and* proficiency at procuring and growing/proliferating clients. However, most firms also look at many other factors to evaluate an individual's total contribution. Those factors include responsibility for client relationships and managing portfolios of work among existing clients (both requiring that the client accepts you in these roles), work/service quality, management/leadership, marketing/firm promotion, development of oneself and others, fiscal stewardship, good corporate citizenship and the like.

Achieving internal equity requires careful consideration of the full basket of contributions that each firm values – including how to measure performance, its relative importance for that individual and overall, the performance trend over time (improving, static or declining), the appropriate consideration of efforts and results, risks taken and lessons learned. Doing this well requires mechanisms to facilitate a consistent and thorough assessment of each individual, and to ensure that each evaluator is undertaking the review with a similar set of measurement references.

Large research studies as well as our work with individual law firms consistently show the performance factor that most highly correlates with lawyer compensation is personal productivity measured by fees collected. It is interesting to note that this factor (revenue per timekeeper) most highly correlates with high law firm profitability.

Partners also contribute by procuring clients. Indeed, demonstrated business development ability is a critical element of the requirements for a fully contributing partner[4]. The highly active and competitive market for lateral partners illustrates this through its emphasis on the portfolio of work that will come along with a lateral partner and his/her team. Historically measured by gross revenues, partners' practices are now examined more closely to understand how a portfolio will contribute to partner profits and competitive position. Only occasionally does a particular expertise, skill, experience or geographic presence (including the jurisdiction license, local knowledge and contacts) drive the recruitment decision.

While other attributes are also vital, these two economic contributions (personal productivity and client procurement) are really the heart of what sets the most significant portion of partner compensation in private law practice. The two combined typically explain between 82% and 87% of the compensation decision. The remaining 13% to 18% is explained by other factors.

Even in those firms that use a lock-step methodology – unusual in the United States – market forces prevail. These firms achieve economically rational results through extremely strict standards of admission into the equity ranks and careful monitoring of each individual's career growth once there.

EXTERNAL COMPETITIVENESS AND FIRM PROFITABILITY

In addition to the basic goal of having compensation align clearly with contribution, research shows that the fairness of compensation is also judged by two other factors: perceptions of what other organizations pay for similar work and the employer company's profitability[5].

When firms benchmark compensation they examine many variables but often fail to factor in performance. Pay should be in line — competitive — with the market for similar performance.

The firm's profitability is important because it will affect the ease or difficulty a firm has in making compensation decisions that competitively align with external pay. Firms with high overhead (the fixed cost of operating the business) relative to revenue and/or low margin (the profits generated by other timekeepers) will struggle to pay at market levels. Partners in such firms are more likely to accept the differential if the overhead burden and margins are consistent with their firm's operating philosophy. However, the difference between market and the firm should not become too great for too long, as partners' tolerance is unlikely to last.

REGULAR COMPENSATION REVIEWS

We generally recommend a review of compensation programs every several years. This does not have to be led by an external consultant each time. But it is good to revisit the best practices presented herein and consider how your program is serving your firm.

Firms change over time as partners come and go, markets evolve, practices grow and wane and clients' needs/preferences change. The compensation program must evolve in response. Slow incremental adjustments are easier to implement and create less disruption than more substantial, episodic overhauls.

SUMMARY

Earlier we discussed that changes in the legal profession have made compensation decision-making more difficult. Several specific firm challenges require specific compensation and non-compensation remedies expanding the role and efforts of compensation decision-makers. These challenges include the underproductive partner, the non-equity partner model (pay, structure, and management), the retiring boomer generation cohort group (including succession and transition issues), paying key partners, paying leadership (particularly the Managing Partner in very large firms), distinguishing profitable work, clients and practices in compensation, disruptive partners and communications (managing expectations, linking input and feedback with strategy and values). Equity in compensation decisions is important because it engenders trust in the credibility of firm leaders. These decisions are the most tangible expression of what is valued in a law firm. When aligned with leaders' stated priorities, trust and confidence is enhanced. When they are misaligned, trust and confidence wanes. While good compensation is unlikely to drive performance, inequitable compensation decisions will hurt morale and consequently diminish performance.

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ENDNOTES

1. Bette Davis, as Margo Channing in *All About Eve*.

2. Maister, D., *Practice What You Preach*, New York: The Free Press, 2001.

3. Collins, J., *Good to Great*, London: Random House, 2001

4. See the author's article, "Who Should Be a Partner in a Post-Recession Profession" available at www.altmanweil.com.

5. Sirota, D., Mischkind, L. and Meltzer, M., The Enthusiastic Employee, New Jersey, Prentice Hall, 2005.