

PAY FOR PERFORMANCE – COMPENSATION SYSTEMS REVISITED

by Peter A. Giuliani

While visiting a wash-room in the vicinity of Princeton University, I recently spotted an interesting bit of graffiti (or graffitus, if one is a Latin purist). On the wall was inscribed Einstein's well known equation regarding the conversion of mass to energy: " $e = mc^2$ ". Beneath the formula was scrawled: "Very good, Albert, but next time show your work!"

That sort of expresses the way I feel about so-called "objective" systems of determining partner compensation. Once in a while, one finds a simple formula which produces an elegant result. But what is more often most valuable is the process by which it was derived, especially the debate over what attributes the formula should take into account.

The problem with data-driven systems is threefold. First, no set of data or formula can encompass all the things you want to reward, so some positive behavior goes unrecognized. Second, people will always find ways to "game" the statistics. Decisions are only as good as the data on which they are based, and many such systems are driven by manipulated data. Finally, they do not give firms the management tools needed to encourage team-oriented behavior.

Compensation systems need to blend the motivational aspects of objective performance evaluation with the notion of partnership and mutuality of interests. The purpose of a law firm partner compensation system should be to both *reward* and *motivate*. The reward should be for long-term dedication and contribution to the success of the firm.

The best law firm compensation systems have the following attributes:

- **They are inherently simple and easy to understand.** Keeping it simple lets partners focus on the most important criteria.
- **They are generally perceived as producing a fair allocation of income *over the course several years*.** While they may be perceived as possibly unfair to some minority interests in any one year, the end result should be a feeling that "rough justice" is done by the system over the long term.
- **There is some recognition of seniority, longevity, return for ownership risk, etc.** Partners are different from employees. They have capital, personal assets and careers at risk, both in terms of business risks and in terms of professional liability. Partners also assume the risk of collection of accounts receivable, defer current income to build for the future, fund inventories for young associates who are starting up, etc. Part of a partner's compensation should reward him or her for bearing these risks.
- **The system is sufficiently merit-based to *directly* address the three things that partners or shareholders must do to build and sustain a successful law firm, namely:**

- Work hard enough on behalf of clients to “earn their keep”;
 - Generate business for the firm by either introducing new clients, expanding existing client relationships, cross-selling skills or bringing new skills to the firm that can be marketed to both new and present clients;
 - Delegate work to associates and paralegals, where appropriate, and supervise the work to ensure that associates’ careers are developed profitably.
- **They are largely prospective in the way they work.** It is important to focus partners’ or shareholders’ attention and interest on the future, rather than the past. Compensation systems that focus entirely on “whacking up the pie” for last year are less useful than those that set income shares prospectively, albeit based upon some record of past performance.
 - **They give some credit for firm management responsibilities, but not so much that “management” becomes a substitute for client work.** For those partners who are asked to serve in managerial capacities, there should be some compensation for doing the job well.

In addition to the attributes listed above, some systems *indirectly* take into account other contributions to the firm, such as bar activities, community service and other image-enhancing activities. I do not wish to denigrate these activities. They are important and - as many would argue - part of a law firm’s duty to the profession and to society. But such activities should be *directly* recognized in a compensation system only if they *ultimately* produce long-term economic benefit for the firm. Presumably every lawyer in the firm has an obligation to pursue such activities for the good of society and the profession; presumably the reward for engaging in such activities is the privilege of practicing law.

Most firms value economic contribution more highly than seniority or other “soft” values. In fact, many firms are moving gradually towards merit-based systems for compensating partners. The simple facts are that many firms are facing an erosion in traditional sources of business. With less “institutional” work to go around, it is harder to rely on pure lock-step, subjective or other egalitarian systems. The partners who produce the business to replace eroding shares of “institutional” work are becoming very important and demand to be recognized for their contributions.

To be sure, one can overcompensate for origination. Someone still has to perform the work, keep the client satisfied, “bond” with the client and expand the relationship. The success of any compensation system will depend upon whether and how it rewards a “balanced” approach to law practice. In the end, serving the client attentively, understanding the client’s objectives and facilitating their attainment and providing value-added service are the most important aspects of the behavior a firm wants to develop in its partners. The compensation system should motivate partners to strive for these all-important elements of quality service. If a

compensation system encourages file-hogging, lack of teamwork in developing client relationships, internal squabbling over origination credits, etc. clients will eventually catch on. Once they catch on, the generally move on!