Aligning partner remuneration with strategy

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1. Abstract

Many law firms believe that aligning partner performance closely with remuneration is the best way to encourage partner behaviour that maximises economic value to the firm. This chapter explores one aspect of that hypothesis, namely the use of partner remuneration to encourage partner behaviour to align with (and preferably drive) execution of the firm's business strategy. It also explores how desired partner behaviour may vary according to the nature of the legal services produced.

The author concludes that while the literature is ambivalent on the use of compensation generally to drive behaviour (with some sources claiming it to be ineffective), the use of partner remuneration as a lever for driving strategy execution can be effective where the strategy is well articulated and where action is effectively driven through clear, realistically achievable business plans at firm-wide, functional unit and individual partner level. A model is presented for how, in practical terms, law firms might use their partner remuneration systems in this way.

2. How successful are incentive-based partner remuneration systems?

Can partner compensation effectively drive partner performance, in terms both of direct economic contribution to the firm and through 'non billable value-added' activities? That it can is well entrenched in received business wisdom – not only in law and other professional services firms but also in business generally.[1] Yet, much confusion exists as to how effective incentive-based systems really are. A number of successful law firms on both sides of the Atlantic, including several of the premium global law firms, remain with 'lockstep' systems that are now regarded by others as old-fashioned, on the grounds that the internal competitiveness, loss of collaboration and other negative

1 Larker (1990).

consequences more than offset the benefits of linking partner compensation directly with performance. Are they wrong? Would they do better with something different?

Certainly, lockstep compensation systems are under pressure. Those firms that find themselves modifying these systems, however - frequently very reluctantly - do so generally for one of two reasons:

- they find themselves struggling to match remuneration for their highest performing partners against that offered by firms with heavily incentivised systems (In other words, what is called an incentive-based system may really be a tactic to deliver market-competitive remuneration to partners that the firm cannot afford to lose.);

- they find themselves under financial pressure and think that by having their partner remuneration system reward production more directly, partners will work harder and deliver more. (The evidence in the literature generally suggests that this logic is flawed.)

On the other hand, some of the most prominent and profitable law firms in the world really are heavily incentive-based in the manner in which they share profit among their partners. In most large, modern law firms, the economic contributions that different partners with different practice areas make can vary widely. Incentive-based systems, when properly calibrated, can match all those different partners with what their competitive value would be into an effective system that also recognises variations in contribution for other reasons.

If the real driver of compensation is supply and demand and the quantum of remuneration earned by the firm's highest paid partners is more heavily influenced by availability of other options in the market than the outcome of any formal incentive-based remuneration model, then the firm may find itself having to apply exceptions constantly. This can cause unhappiness on the part of other partners, who may feel that the formal remuneration system excludes the highest earners in that system – sometimes even if their behaviour harms the firm by hindering achievement of its strategic objectives or in other ways.

Does one 'best practice' model of partner compensation exist that is the most likely to optimise economic performance and deliver sustained competitive advantage? What factors can influence whether a particular model delivers the results anticipated better than another? What other options besides remuneration exist to align partner behaviour with that which is required in order for the firm to achieve its strategic objectives? Given today's volatile market conditions and changes under way within the legal profession, how do different partner remuneration models help or hinder matters when strategy needs to change direction suddenly? These are crucial questions, not least given the propensity of so many law firms to try to address issues of economic performance by first tinkering with their partner remuneration model.

Irrespective of the kind of partner remuneration model employed, a wide range of other factors also influence what a partner needs to be paid for that partner to remain in the firm, perform well and be engaged with other partners and with the overall success of the firm. As with many aspects of professional service firm management, partner compensation is complex and fraught with inconsistencies and ambiguities. Unintended consequences should be expected as a matter of course when systems are changed and allowance made for dealing with these as they emerge. This chapter aims to provide guidelines for law firm leaders in addressing one specific facet of this, namely the alignment of the firm's partner remuneration scheme with the achievement of its strategic objectives.

3. Generic remuneration models and their link to strategy

In general terms, two schools of thought exist with regard to partner remuneration.

- *Universalist theory* holds that a common 'best practice' does exist and that, other factors being equal, firms applying this model will more easily achieve superior economic performance and sustained competitive advantage. In law firms, this approach is probably typified by the 'lockstep' or (perhaps in most recent times) the so-called 'modified lockstep' model. Proponents of incentive-based models could, however, just as easily argue that this applies to their models.

- *Contingency theory*, on the other hand, holds that value is only realised when the elements of the organisational design, including such human capital practices as performance management, career and competency development, remuneration and reward, are well aligned with the firm's strategy, which in turn is optimally aligned with the mix of threats and opportunities in the market and with the strengths and weaknesses within the firm.

Corporate strategy has been defined in a number of ways over the years, but the most important common threads between the various definitions[2] are that:

- it is the position that a firm chooses to occupy in the markets (in the case of a law firm, typically the mix of clients and services and markets in which it chooses to compete);

- it reflects the perspective that the partners in the firm have for their business together (vision, brand, direction);

- it determines the mix of activities in which the firm chooses to engage in order to deliver a unique mix of value to clients;

- it is the way in which the firm chooses to optimise its competitive advantage, which can be reduced to three generic approaches, namely –

    - cost leadership (ie, being the lowest cost amongst suppliers that can adequately deliver the service);

    - differentiation (ie, being different to the competition in ways that clients value, such that they are prepared to pay a premium for the firm's services);

    - exploiting a niche (ie, focusing on areas in which demand for a particular service exceeds supply, so that, again, clients are prepared to pay a premium); and

- whether or not a formal strategy/strategic plan exists, the 'real' strategy of a firm is reflected in the pattern of decisions and investments that it makes about its overall objectives, which lead in turn to the principal plans and policies for achieving these.

Over the years, many theories have been developed to describe the way in which law firms pay their partners and employees in ways designed to encourage particular behaviours; these ways are usually heavily skewed in favour of production, but frequently also include contribution to the achievement of the firm's strategic objectives. The legal profession is not a uniform construct. Drivers of economic performance and of sustained competitive advantage vary widely from, for instance, a top tier New York or London firm to a small provincial law firm to a legal process outsourcing (LPO) business to a high-end

2 Combining Andrews (1984), Mintzberg (1993) and Porter (1986).

litigation boutique. The strategies that each must employ in order to generate the best possible sustained economic return for its partners is also different. (See figure 1.)

Continuing that logic, it follows that the behaviour that one would expect of both partners and employees in order to achieve the firm's strategic business objectives must also vary widely across those different kinds of legal service provider. On the face of it, therefore, accepting the validity of universalist theory as a uniform construct across the legal profession would seem impossible. It would, however, be quite valid across legal service providers with similar characteristics to each other.

Perhaps the existence of a 'best practice' model of partner remuneration, from the perspective of aligning with the firm's strategic business objectives, depends more on the partnership's appetite for influencing individual partner behavioural alignment and sanctioning those who behave otherwise. This is also not a new idea. The success of a lockstep-based partnership has always relied upon the willingness to sanction those of its members who under-perform, including in terms of a partner's alignment with firm-wide strategic objectives. Difficulties arise when the partner who is behaving badly is a significant producer of revenue. In that case, applying sanctions can have a very direct economic impact.

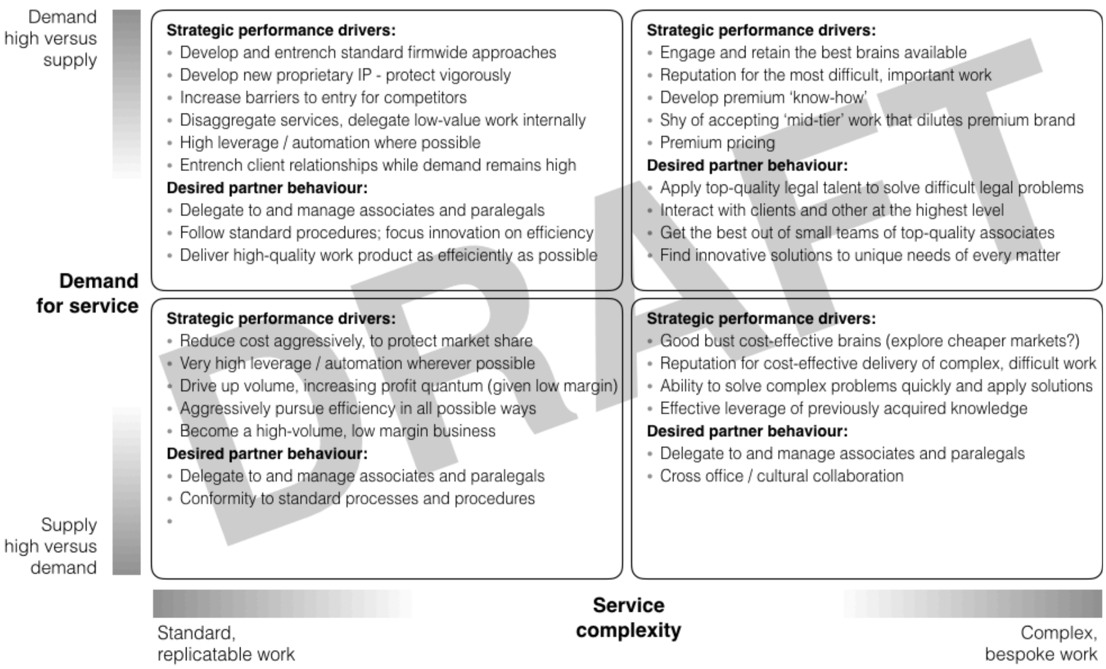

Figure 1: *Illustration of how strategic performance drivers and desired partner behaviour vary according to the strategic characteristics of the service delivered. (Source: author)*

A further complication which inevitably arises is that the optimum strategy may vary quite significantly across offices within the same firm. Some of the largest global law firms have opted for 'verein' structures that keep profit pools separate precisely to manage this tension. Even within a single office, if that office is of significant size, one may encounter strategic tensions between different practice areas, client teams, functions or other sub-firm groupings. Unique characteristics and drivers of each may indicate a different optimum strategy for key issues such as pricing, leverage and approach to client relationship management. Figure 2 illustrates how the complexity of partner performance assessment can vary according to the range of practice areas being offered and the number of markets in which the firm operates.

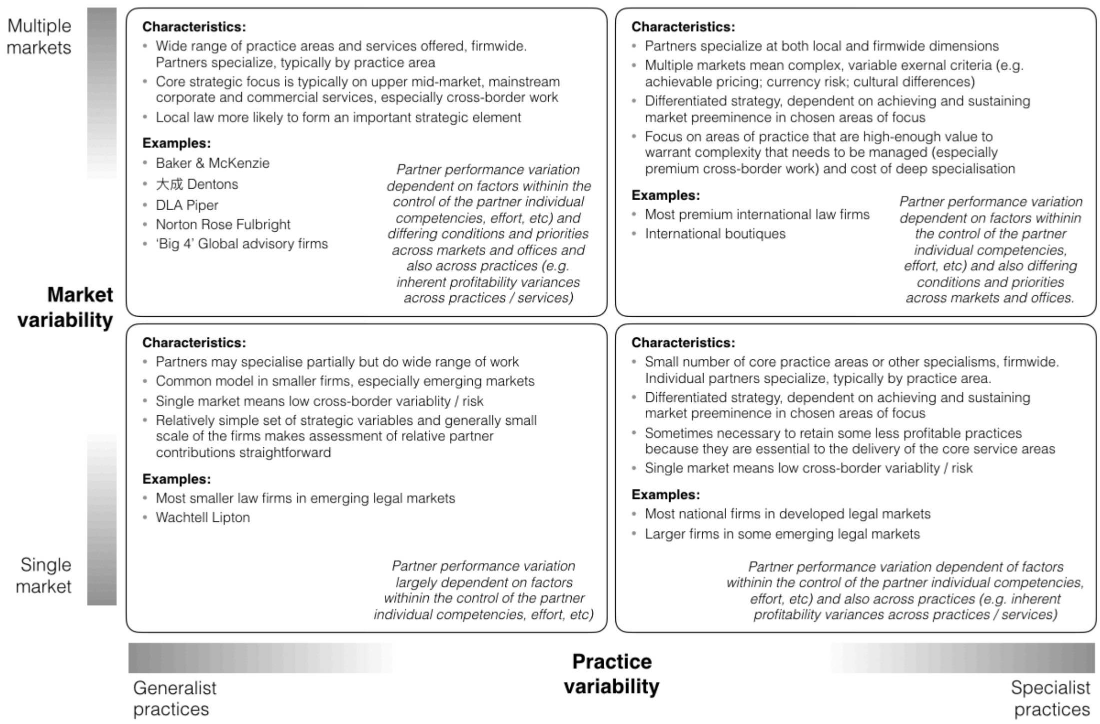

Figure 2*: Variability in drivers of partner performance and the complexity of assessing individual partner performance across multiple offices and multiple practice areas. (Source: author)*

These tensions may render some partners less able to influence their own performance than others. Further, the inevitable compromises that a rigid 'one size fits all' approach to strategy across radically different sub-units may not only sacrifice economic performance and sustained competitive advantage, but may also render the fundamental approach to performance assessment and incentive-based remuneration inequitable.

Figure 2 shows how firms delivering highly variable services require very different partner behaviours if they are to deliver optimum performance, by comparison with those that deliver more standardised services. Likewise, desired partner behaviour varies according to how dispersed the firm is across multiple markets. Teamwork across different geographical areas with different cultural attributes and across multiple time zones, for instance, takes on very different dimensions than is the case in a single market and perhaps even a single office. Plotting these two variables against each other also creates four sets of desired partner behaviour in terms of aligning with the requirements of the firm's strategy. This exercise may also be done with other variables and serves to illustrate that it is frequently easier to measure performance against achievement of objectives that the desired partner behaviour is intended to deliver than it is to measure that behaviour itself.

Incentive pay, especially when the metrics become complex or, worse, vague, almost always causes partners to 'game' the system, sometimes even leading to behaviours that may hinder achievement of the firm's strategic objectives. When incentive plans are put in place, an adversarial relationship also frequently develops between the system designers or those managing the process and those whose performance is being measured. Disconnects are common and can have serious consequences. A recent study[3] concludes that -

> "the 'gap' between what is desired strategically (the pay approach) intended as policy (the pay design) and achieved as pay practice (the pay operation) is an important recognition of the fallibility of strategic pay."

This study also concludes that although the vast majority of companies claim to use remuneration strategically, the reality is that most such systems behave tactically in setting remuneration. As previously noted, this especially the case for the firm's most important fee-earners, where the real approach is highly reactive to what competitors would pay in order to persuade them to defect. Partners who practise in areas that are in lower demand, even cyclically, or who make less of a financial contribution to the firm for other reasons, find their remuneration pruned in order to retain these star performers. No judgment is passed here on whether this is a good or a bad thing. It is simply a reality that

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3 Trevor (2011).

needs to be recognised in developing a system that would deliver what is intended.

An important factor, largely overlooked by research to date, is the importance of how the management of partner remuneration systems is approached. One of the most important issues is the degree to which the remuneration system is central or devolved. In almost all cases studied, local business leaders found trying to grapple with the complexity and challenges seemingly inherent in the process too difficult and attempted instead to make centrally imposed remuneration policies 'work.' The linkage between remuneration strategy and realised practice is particularly problematic. Thus, if the remuneration strategy under discussion is "to encourage partner behavior that supports and to the extent possible actively drives achievement of the firm's strategy", this raises two questions: firstly, how this is achieved in practical terms and, secondly, how remuneration interfaces with the other issues that drive desired partner behaviour.

Some of the objections that partners might raise against their performance being assessed in terms of their contribution to the achievement of the firm's strategic objectives might include that those strategic objectives are:

- not clearly articulated or communicated;
- not realistically achievable;
- opposed (actively or passively) by significant power bases within the firm;
- of such a nature that it is difficult to assess whether they have been achieved;
- intangible in nature and so not capable of being translated into specific action;
- not being adequately funded in areas for which they are responsible;
- inconsistent with the needs of their most important clients;
- not relevant to their practice areas;
- dependent on the actions of others or otherwise beyond their control;
- that their high billing performance excuses any failure to support strategy;
- no longer appropriate, given a change that has occurred in the interim.

In all of these examples, the problems in linking support for execution of strategy to partner remuneration derive more from deficiencies in the way in which strategy is crafted and translated into action and results than in the modality of the remuneration system itself. It does not advance the thinking about whether a ‘best practice’ exists (universalist theory) or whether the best remuneration system for a particular firm is closely dependent on its strategy (contingency theory). Reverse causality is another complicating factor (ie, do firms that employ ‘best practice’ become successful because of that, or are firms that are successful for other reasons simply more likely to employ systems that conform with what is regarded as ‘best practice’?).

Irrespective of whether or not a specific empirical research basis exists for the use of partner remuneration as a tool to influence partner behaviour, clearly its use has become so widespread as to represent the current received wisdom in practice. Even in lockstep systems, where remuneration is based exclusively or largely on seniority in the partnership, this is nonetheless implied because such systems only work if consistently under-performing partners are asked to leave the partnership – but in ways that do not create ill-will on the part of those partners!

The rationale for a lockstep is theoretically unassailable if partners feel that they all contribute more or less equally to the firm’s success, given their level of seniority. It holds that if all partners are remunerated equally in seniority bands, on the basis of the overall profits of the firm, then there are no impediments to collaboration and all partners will work together to optimise the economic performance of the firm. Systems that reward partners on the basis of individual performance kill collaboration, so the argument goes. Locksteps also reward those who have been partners the longest. Junior high-flyers are encouraged to take a longer-term view of their careers and may be rewarded out of a bonus pool for extraordinary short-term performance. As figure 2 shows, however, it has become increasingly difficult to sustain a model that is based on the assumption that all partners of similar seniority contribute equally. In developed legal markets at least, it requires a business model that both restricts itself to markets that are macro-economically similar (or develops mechanisms to overcome their differences) and resolves the tension caused by the fact that some areas of practice are inherently more productive than others.

This point is well illustrated by the fact that during 2015 and continuing into 2016, significant numbers of partners were recruited from prominent London law firms into the London offices of US-based law firms for higher but performance-based remuneration packages. The London ‘Magic Circle’ firms are renowned for their ability to institutionalise client relationships, so this was not simply a matter of the US-based firms acquiring those partners’ books of business. For the partners who made the move, there was a measure of risk involved in leaving the comfort of a lockstep remuneration system in which their positions as high-performers were secure. For firms in which the level of contribution by individual partners to the firm's overall economic performance varies significantly, holding a lockstep together can be a well-nigh impossible task. Small wonder, then, that several of the London firms who found themselves on the losing end of these defections are re-examining their locksteps in order to discover ways of modifying them without losing the inducement to collaborate that is so important to their cultures and to their ability to function as premium global businesses.

4. The framework for an effective partner remuneration system

In assessing which partner remuneration system will best drive behaviour that supports the achievement of the firm's strategic objectives, one has to approach the issue at three levels:

- *The approach to remuneration*. This means the implicit or espoused values, principles and aspirations that underpin the system. Behaviour which supports or drives achievement of the firm's strategy is not the only consideration around which to build the system. An integrated approach therefore needs to be adopted that would include, firstly, other areas of desired behaviour that the system seeks to encourage and, secondly, other areas that the remuneration system needs to recognise - most importantly, market competitiveness of the results, which is usually a factor that is driven heavily by fee-earning combined with the mobility of a particular partner's client base.

- *The design of the remuneration system*. This means the technical content of the remuneration system, including how it will be structured, which performance metrics will be included, what kind of information will be collected and distributed, any formulas and procedures that will be applied and how variability across practice areas, markets and other dimensions will be resolved.

- *The operation of the remuneration system*. This means how the system will be operated, in practical terms. It is essential to reflect on how partners will 'experience' the assessment and remuneration systems within the firm and for the process to deliver the required results required with the minimum of disruption. How will fairness not only be ensured but be perceived to be so? Will the system be 'open' (with partners knowing what each other earn) or 'closed' (where this information is kept confidential?) Who will serve on the remuneration committee? How, in practical terms, will they go about their work? How will the appeal process (if any) work?

In many firms, the process of assessing remuneration is unnecessarily contentious, even traumatic. This harms collegiality and wastes an enormous amount of time that could otherwise be used on productive client work. Except in systems that partners have agreed should be 'closed' (the tiny minority) it is probably impossible to avoid at least some disagreement. The key should be to develop a system that partners agree is transparent, generally fair and equitable and which probably delivers the best results for their firm, including encouragement of behaviour that supports the achievement of the firm's strategic objectives.

Much of the research in the field of remuneration and reward has focused on corporate systems, where the separation between the leader/managers in the firm and its shareholders is usually distinct. In corporate models, owner/practitioners draw income both as employees (usually with a mix of base salary, bonus and other benefits.) In partnerships, the owners typically draw no salary, only 'profit share' which is a share of the revenues that remain after costs of non-equity owning employees and other overheads have been paid.

This means that remuneration options available in corporate business models, such as separation of base salary plus bonus (the latter based on individual and team performance) and dividends (based, by definition, on company results) are not readily available to partnerships; nor are other inducements to adopt a longer-term view, such as stock options.

5. Integrating partner remuneration into the strategic planning process

For a law firm's partner remuneration model to be effective in driving the behaviour required to support the achievement of the firm's strategic objectives, it must be closely integrated into the firm's strategic planning process. Key to this is making the firm's strategy relevant at every level, from firm-wide right down to the individual partner.

Since the 'Balanced Scorecard' (BSC) approach to strategic management was first introduced in 1992, it has become ubiquitous among professional service firms in recognising, at least nominally, that some aspects of behaviour besides raw economic production need to be actively managed in order to achieve strategic objectives. The first generation BSC used a four-perspective approach to identify and monitor metrics to track strategy execution:

- financial;
- client;
- internal business processes; and
- learning and growth.

The concept has undergone a number of iterations over the past quarter century through 'strategy maps' and 'results-based management', all in efforts to translate strategic intent into action better and to encourage feedback and learning, which in turn may lead to adjustment of the strategy.

Figure 3 illustrates a model for developing and executing strategy. In this model, the best strategy for the firm is defined as the mix of the clients, services and markets in which the firm chooses to compete, given the suite of external threats and opportunities it faces and its internal strengths and weaknesses.

In the second column, 'How will we compete,' the balanced scorecard approach is used to define not four but six perspectives under which the firm sets objectives, first at the firm-wide model and then at the model of each sub-group within the firm (eg, practice area, business services function, industry sector group, key client team, region or office). In cases where the objectives straddle several sub-units or accountability cannot be easily allocated, the objective should be tackled through a strategic project, with specific resources allocated, accountability assigned and milestones and timeframes agreed. Once those objectives have been set and the measures of success agreed by which their achievement will be measured, a final critical step is for each partner to develop his/her own personal business plan, outlining those aspects of the sub-unit business plans for which he/she is prepared to accept responsibility.

This approach is also nothing new. Like the balanced scorecard, it has been in use in mainstream business for many decades. It is essentially a variation on the principle of 'management by objectives' first popularised by Peter Drucker more than sixty years ago. What is unusual for law firms is linking direct accountability for achievement of defined, tangible individual strategic objectives - the aggregate of which would deliver achievement of the firm-wide strategic objectives - directly to partner performance assessments. Until recently, partners were under far less formal scrutiny with regard to anything except production (fee-earning) targets. Objectives and targets with regard to 'non-billable value added' efforts were typically addressed subjectively and informally, if at all. In today's hyper-competitive environment, this is simply not enough. In the model illustrated in Figure 3, no reference is made to financial targets. This is because the current financial target is a function of the business plan, not strategy. It is a given that partners and their teams have revenue levels that they must reach in order to deliver the profits that the firm requires. From a strategic perspective, the areas in which objectives should be set and action plans developed to achieve them are discussed below.

6. Client satisfaction

An extensive research project by Bain & Company and the Sloan School of Management at MIT (Reichheld, 2006) has shown that a 50% probability of long-term retention of a client relationship required a 4.2/5 score for the question: "How likely is it that you would recommend our firm to a friend or colleague?" This score has been termed the 'net promoter score'. Given that longevity of the relationship is a key driver of the net present value (NPV) of the revenues that the firm will earn from a client, it follows that specific objectives should be established to drive up the net promoter scores of not only the firm's most important clients, but also emerging new clients that could become the firm's most important clients in the future.

7. Efficiency

Given the hyper-competitiveness in legal services markets in many parts of the world, efficiency has of itself become a strategic objective. In efforts to drive down the transactional cost of advising clients while preserving margins, firms are experimenting with a wide range of cost-cutting initiatives. These range from legal project management to optimising and aligning processes both in the practice and in business services, new pricing strategies, disaggregation of service processes and sourcing them more intelligently. At an extreme, some firms are moving towards an 'ecosystem' approach not dissimilar to that employed by companies such as Amazon and the *kaizen* systems of the Japanese auto industry, to develop a network of business units both inside and outside the firm, in order to deliver services of the quality required to sustain a high net promoter score at a competitive price.

8. Continual improvement

In order to ensure that the firm sustains a position of competitive advantage, it needs continually to improve the depth and technical quality of the services that it delivers. All legal services move, slowly or rapidly, through a continuum of emergence, growth, maturity and then saturation or even decline. Client cost sensitivity is less with the first two of these, so firms that fall mostly within the top two quadrants in Figure 1 need to evolve their service range constantly, withdrawing from services that have matured and developing new areas that are emerging and have the promise of growth. For firms that have business models geared to lower margins, the opportunity exists to win market share from firms with higher cost bases as services mature. In practical terms, this evolution takes place by design at the practice group level and through the individual choices that partners make about which matters they will accept and decline.

9. Talent engagement

The level of engagement of employees in a particular business unit correlates strongly with the financial performance of that business unit. In a world where associate/trainee intakes are smaller and attrition needs to be less, talent strategies have become an important subset of the firm-wide strategy. Internal unpublished research within EY (Ernst & Young) indicates that the principal drivers of employee engagement in that firm are interesting, challenging work, effective teaming and recognition. Personal professional development is also important. Enhancing levels of employee engagement and, of course, partner engagement also, are therefore directly linked to the medium to long-term economic performance of the firm and are worthy of specific attention in the firm's strategy development process. Likewise, metrics for assessing how partners are performing in enhancing employee engagement levels are relatively easy to identify. Including this in the assessment process in conjunction with an incentive-based remuneration system could be one of the most effective ways of aligning partner behaviour which strongly drives not only strategic alignment but also, very directly, financial performance.

10. Risk management

This has always been an important issue for law firms but exponential proliferation of regulation, increasingly globalised markets, the scale of potential risk events and the emergence of entirely new levels of concern in fields such as the internet of things, machine learning and cyber security make effective risk management a matter of central strategic concern to law firms in the 21st century as well.

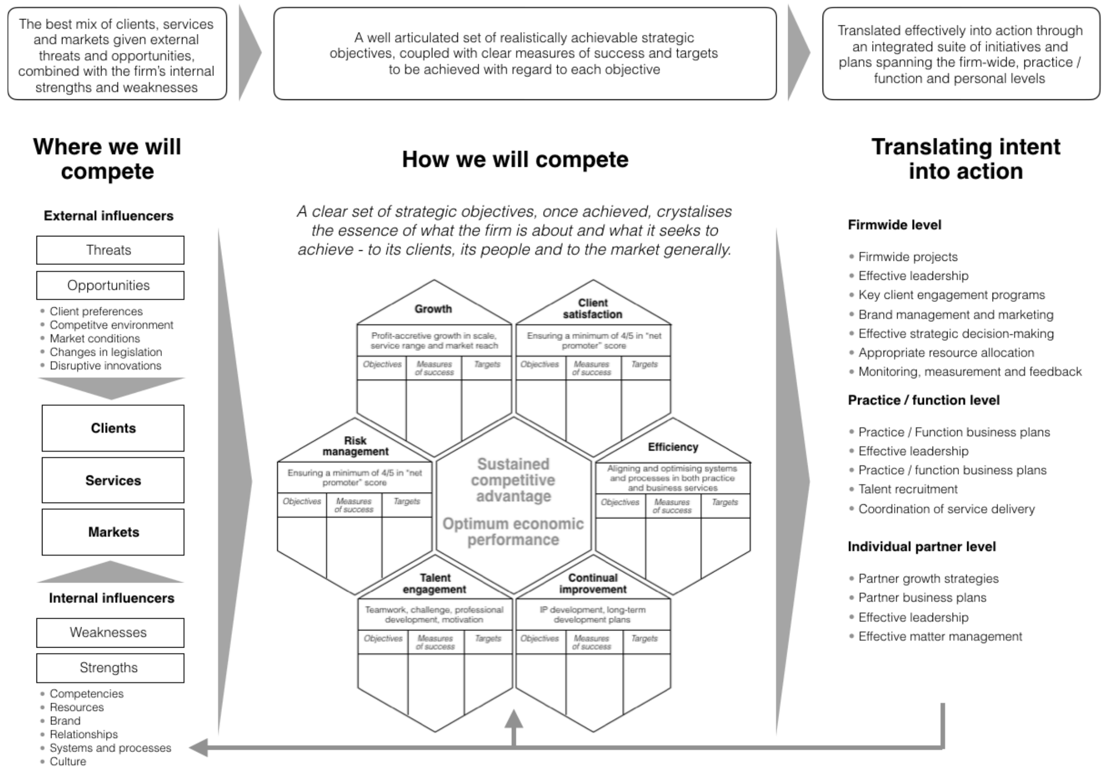

***Figure 3**: A model for professional service firm strategy, linking the development of the best mix of clients, services and markets ('where we will compete') to the setting of strategic objectives at firm-wide, sub-unit and individual partner level ('how will we compete') and defining the factors that will influence the achievement of those objectives. Key to this is the incorporation of individual partner objectives into the assessments underpinning the partner remuneration system. (Source: author)*

11. Integration of the group objectives into individual partner business plans

An individual partner business plan should be a document of no more than three pages and a standard format should be agreed so that the content is tight and focused. It should contain, in bullet point format, the key objectives for the year, in terms of revenue projections, support of strategic objectives (using the same six perspectives set out in the 'How we will compete' column in figure 3) and personal professional development. Narrative should be kept to a minimum. Intended actions should be outlined and the 'measures of success' noted so that whether or not a particular objective is achieved, it is able to be definitively determined. Each partner's business plan would be different, but the aggregate of all the individual plans, through the sub-group business plans and the plans for the firm-wide strategic projects, should deliver the firm-wide strategic objectives.

In effect, the personal partner business plan becomes a contract between that partner and the firm or, more correctly, with his/her fellow partners. Provision should be made for the contract to be varied should circumstances dictate, but this should be a formal process so that it is taken seriously and amendments are made with due regard to their impact on the achievement of the firm-wide strategic objectives.

Irrespective of whether or not the results of the partner performance process feed directly into an incentive-based remuneration scheme, the partner's success or failure to achieve his/her own specific goals then becomes the primary measure of that partner's performance.

12. Summary

From a theoretical perspective, this model of strategy suggests the universalist model to be at least partially correct, in that overarching principles exist that define a 'best practice' that can be applied with good results across all types of law firm. Key to all variations is that the remuneration delivered to high value partners that the firm would not want to lose is competitive with those partners' options elsewhere in the market. This remains true whether the system in question is lockstep or incentive-based; subjective or objective or formulaic; open or closed. Beyond that key consideration, considerable scope exists to tailor a partner remuneration scheme aimed at encouraging the kinds of partner behaviour that would deliver the best performance under the generic strategy (as per Figure 2) and achieve the best results given the kind of legal services delivered to clients and yet provide further scope for introducing elements bespoke to each individual firm.

Within this approach, one could define an almost infinite range of strategies. Indeed, it is said that there are as many law firm partner remuneration systems on the earth as there are law firms. The key differentiator between success and failure is frequently not the theoretical elegance of the system, but the faith on the part of the partners that it is equitable and fairly administered. This applies both in general and to the degree that the system seeks to encourage alignment of partner behaviour with the execution of the firm's strategy.

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