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Finance: Is your compensation strategy on the money?

In the second part of a series of articles on profit-sharing, Neil Oakes discusses what motivates lawyers to perform at their peak.

There is little doubt that as firms commercialise, evolving from collegiate fraternities to professionally managed businesses, most have embraced some form of performance-based compensation for partners.

Many commentators, advisors and academics maintain that performance-based sharing is consistent with modern management and motivation theory: "give 'em an incentive, a reason to perform and stand back."

Theoretically we all respond to financial incentive by changing behaviours and improving performance. Oddly enough, many firms that share profits equally outperform those that do not and many do not. In fact, there is a poor correlation both nationally and globally between profit-sharing methodology and firm performance.

Profit share (and partner entry-exit) should be strategic. It should have, as its *raison d'être*, a set of aims and objectives. I often encounter firms whose sharing methodology has morphed over time, not to achieve strategic business goals but to placate angry over-achievers. Similarly, I encounter firms who plough on with equity-based sharing (cutting the pie relative to ownership) or equality, regardless of prolonged performance differences within the firm.

Motivational forces

There is a stack of learned literature that details workplace motivation; what drives us to succeed. True, it varies from person to person, but I suspect that people are not born with a set of motivators. They are conditioned. The desire to rise, for instance, is probably significantly stronger for someone who spent their childhood in poverty than it is in someone who enjoyed a comfortable existence on Sydney's North Shore. Sure, parental pressure can whip up a desire to rise, and so too can many other phenomena. My point is that it is conditioned, not innate. Of course, conditioning can occur over short timeframes. In my experience, partners that earn seven-figure incomes become conditioned to them phenomenally quickly!

Despite this, most professional service firms do not offer performance incentives to employees. We usually pay a salary, negotiated annually in a performance review that reflects market worth and

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internal relativity more than individual performance. To complicate this, in recent years the direct consequence of not achieving budget performance has been a pay rise.

We take employed practitioners who have never before encountered performance-based pay, never been directly compared to their peers and expect them to thrive in a performance-based partnership. Strangely, many do, but sadly the majority do not.

If we sampled a group of law firm partners and asked them why they became lawyers in the first place, I bet that few would say “to make heaps of money”. The answers would vary, but they would include altruistic reasons: prestige, never-ending challenge, ego, love of the law and so on. For many, promotion to partnership is more about perceived career achievement than money. How else could one explain the commercially fascinating construct of non-equity partnership, a position that encompasses joint and several liability with your employers.

We all know that objectives and motivators change over time; money becomes important to most at some stage in life. We become partners so we can be business owners and every business owner wants to maximise their profit, apparently.

I would contend that professional service firms are quite different to other types of businesses and that generalising industry theory into the professional service firm world could be both wrong and dangerous. There are even differences among professionals. Nobody likes a complicated formula more than an engineer; accountants do not understand why anyone would be motivated by anything other than money; dentists actually are not motivated by anything other than money; doctors have been done over by the government and forgot what money looked like years ago; and the vagaries of patent attorneys remain the best-kept secret in the country.

Maximising the performance of partners is likely to involve offering them what they were seeking when they became lawyers and subsequently partners, not just pay as a function of their monetary performance. This necessitates a wide definition of performance and a necessarily complex system to monitor and reward.

Firms that have enjoyed great success with performance-based pay usually commence performance-based pay at the commencement of a career. In other words, they condition their potential partners to thrive, long before they become partners.

Perhaps you should determine what you want to achieve as a partnership. I would counsel against changing from equality to something else because “everyone’s doing it”. What do you want your culture to become; what behaviours do you want partners to exhibit and staff to learn; how are you going to

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choose the next group of partners; and, of course, how much money do you want to make? You should then build your profit-sharing methodology around these aims so it helps to create success, tells your staff what you value and what you seek to reward. You should then tailor a similar approach to professional staff compensation. Those who do not fit will have left long before they are considered for partnership.

Defensive play

Leaving aside the top-tier law firms, there is little doubt in my experience that performance-based sharing is usually implemented defensively, as a retention tool ("We need to pay Barry more or he'll go and we can't afford to lose him.")

In some cases, it may be catastrophic to lose Barry, but it usually is not. Barry may go as a result of quantum but rarely as a consequence of methodology unless the firm's current methodology is unequivocally unfair. There may also be a good reason to recognise and reward Barry, but this can be done within the framework of a lock step. There is nothing wrong with one-off or regular prizes and rewards; they make good sense to me.

Redesigning the profit-share system to attempt retention is likely to be unsuccessful. FMRC voluntary attrition figures are no better among the performance-based sharers; in fact, they are worse for both partners and staff.

I am neither for nor against any particular sharing methodology. I know they all work and they all do not work; there is no best method. I also know that the success of any method chosen will largely depend on the culture of the firm, history and relative success.

I would encourage partners to hasten slowly and design a system for all the right reasons. A friend of mine told me an anecdote when he was the chairman of his firm, a major New Zealand law firm. He had recently attended an international managing partners' forum in the US. He recounted the envy with which he and his New Zealand colleagues were regarded because many had stuck with lock step to equality. "All of the Americans", he said, "changed to performance-based sharing and they now long for the simplicity of equality, but they know they can't go back."

Neil Oakes is a director of FMRC Legal. In the final part of this series, he discusses making the transition to partnerships based on equality.
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