James D. Cotterman

Making Better Compensation Decisions

By James D. Cotterman

When I began consulting to law firms 18 years ago, compensation advisory services focused primarily on benchmarking. We would look at market data, find comparables, refine study data to adjust for timing differences, and determine appropriate compensation ranges. This latter focus was partly due to the nationwide run-up in associate starting salaries and law firms' attempts to deal with those market forces and the system-wide compression they created.

Changing Focal Points in Compensation Concerns

Soon, however, our clients wanted us to concentrate more on compensation system design, largely because they perceived a need to be more economically rational during difficult times. We would define performance as those "things" a lawyer did for which the firm would pay. Then we would determine how and when to measure those "things" as well as how much each was worth. The benchmarking did not go away, but it was no longer the central issue. By now the recession and market downturn had quieted the starting-salary markets, a respite that would last for several years.

In the early 1990s, as I began to think and write more about compensation issues, the idea began to form that the compensation system was not the core issue. Lacking research and armed only with my experience assisting law firms with compensation issues, I nevertheless suspected that all compensation systems "work" and all compensation systems "fail." How else could one explain the paradox that a particular formula or system worked at Firm A and not at Firm B? I also realized that each firm put its own peculiar spin on a few core compensation elements. From these concepts was born our first research into compensation methodologies — the *1993 Compensation Systems Survey* — which yielded the first look at how compensation decisions are actually made in private law firms.

As the economic expansion of the 1990s took on a decidedly more robust character, reminiscent of the 1920s, clients continued requesting assistance with their systems but started asking about process as well. These clients were not getting the results they anticipated from improving their compensation systems. Their dissatisfaction stemmed largely from their belief that compensation was an effective motivator — and in some cases from an unstated assumption that compensation could serve as an effective proxy for good management.

By the end of the decade, the hot starting-salary market erupted yet again. Lawyer mobility, not just within the profession but increasingly away from the profession and to high tech ventures with equity participation, was becoming an acute problem. A central issue now was how to get more dollars to the stars and rising stars to stop the poaching of talented lawyers. This concern has continued into the new century.

As 2000 unfolded, the market began to turn, and a recession was rapidly underway. Finding themselves burdened with partners who could not keep themselves or others sufficiently busy, firms sought advice on getting compensation rationalized, as well as on ownership structures and criteria for defining a fully contributing partner. To many firms, "rationalized" meant not only aligning pay with performance but also setting far stricter expectations for partner performance.

Overall Purpose of a Compensation System: A Newer View

In 2001 two excellent research studies were published. One, *Practice What You Preach,*[1] by David Maister, deals with professional services practices, the other, *Good to Great,*[2] by Jim Collins, focuses on large public corporations. Each examines high-performing organizations and concludes that the method of compensation is largely irrelevant as a causal factor for high and sustained performance.

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As David Maister puts 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."[3] He also observes, "The most striking finding is that the most financially successful offices did better at *virtually everything*."[4]

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."[5] 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."[6] 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."[7]

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. And any specific compensation system may or may not be the right structure for your organization to achieve that end.

Equitable Compensation

Good compensation decisions must be grounded in equity. For a decision to be equitable does not necessarily mean that there is an objectively "right" or "correct" compensation level for each individual, let alone that one can precisely determine what that amount is or convince each person of the wisdom and fairness of that amount. Rather, a major goal in making equitable decisions is for all individuals in the firm to strongly agree that, on the whole, those whose labor contributes more long-term value to the organization receive higher compensation (wages and benefits).

In addition to the basic goal of having compensation align clearly with contribution, research shows that the fairness of compensation is judged by two other factors: perceptions of what other organizations pay for similar work and the employer company's profitability.[8]

So how do we incorporate these three factors to make better compensation decisions? Altman Weil has a decision aid that can assist in this endeavor. The aid itself does not make decisions, of course. Rather its purpose is to test your decisions against criteria for the equity factors previously mentioned. Let's discuss each of those factors, how they present themselves in real situations, and how the decision aid approaches each.

What other organizations pay for similar contributions —

This is the external competitiveness component to fair pay equity. Pay should be in line — competitive — with the market.

The performance factor that most highly correlates with lawyer compensation is personal productivity as measured by fees collected. In large surveys where we use the time value of hours worked as a proxy for fee receipts, the correlation factor is 68%.[9] When assessing individual firms using fee receipts, the correlation factor is consistently at similar levels.

Partners also contribute economically by generating client work; indeed, demonstrated business development ability is a critical element of the requirements for a fully contributing partner. The market for lateral partners is very much focused on the portfolio of work that will come along with the partner or his or her team. Only occasionally does a particular expertise or jurisdiction qualification drive the recruitment decision.

While other attributes are also vital, these two economic contributions are really the heart of what sets a significant portion of partner compensation in a private law firm. The decision aid takes both, adds in market profitability data, uses three different measuring points, weights them in an economically rational way and then provides likely market pay ranges. The ability of the aid to predict market pay is an important element in its ability to guide a firm in market competitiveness.

The relationship of pay to individual contribution —

This is the internal equity component. People want to be treated fairly, and their reference points are what other individuals in their firm are paid, what those individuals are contributing, and how they themselves compare to other individuals.

The fundamental notion of "contribution" in most law firms is that partners must be personally productive *and* proficient at generating clients. Most firms, however, also

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look at many other factors to evaluate an individual's total contribution. Those factors include management, marketing, development of oneself and others, and the like.

The decision aid builds on the economic contributions by requesting assessments of performance across six broad categories of qualitative contribution. The result of this additional analysis refines the likely pay ranges developed above. Again the aid assists in aligning compensation decisions with overall contribution in such a way that an individual looking at the compensation should recognize a strong positive relationship between pay and performance.

Relationship to firm profitability — The firm's profitability is important because it will affect the ease or difficulty the firm has in meeting the first criterion — alignment with external competitive pay. The decision aid takes into account general overhead (what it costs to run the business) and the profitability of work. Looking at firm-specific data allows the aid to provide very specific pay ranges that are meaningful to the firm. Adjusting those variables to factor in market profitability further allows one to see how differences in compensation (good or bad) result from owner decisions and management execution.

Why Are Equitable Compensation Decisions So Important?

Compensation signifies more than the relative importance of the individual to the organization. As a tangible expression of a person's perceived value, compensation influences lifestyle, position within a community, and status among peers, friends and family. Compensation is therefore one of the most complex and emotional issues that confront any business enterprise. Economics, psychology, sociology, politics and ethics are all components in the compensation transaction.[10] Equitable compensation decisions also engender trust and credibility in management. While compensation is unlikely to drive performance, inequitable compensation decisions hurt morale and consequently diminish performance. ◆

1 *David Maister,* Practice What You Preach *(The Free Press, Simon & Schuster, 2001).*

2 *James Collins,* Good to Great *(HarperCollins Publishers, Inc., 2001).*

3 *Maister, p. 50.*

4 *Maister, p. 28.*

5 *Collins, p. 49.*

6 *Collins, p. 50.*

7 *Collins, p. 54.*

8 *David Sirota, Louis A. Mischkind, Michael Irwin Meltzer,* The Enthusiastic Employee – How Companies Profit by Giving Employees What They Want *(Wharton School Publishing, 2005), 12.*

9 *James D. Cotterman,* Productivity and Profitability Over a Career in Law *(Altman Weil, Inc., 2004).*

10 *James D. Cotterman, Ed.,* Compensation Plans for Law Firms, Fourth Edition *(ABA, 2004), 1.*

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