WHITE PAPER

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# Merit-Based Compensation and Promotion for Associates: The Challenges of Designing and Implementing a New Approach

Any review of the legal press or conversation with the leader of a major law firm reveals there is growing interest in alternatives to the traditional lockstep compensation and promotion system used for associates. It is clear that law firms are moving in the same direction as most other professional service firms, and switching from a system of promotion and compensation based on time-in-grade, to a system of individualized performance assessment and more variable progression, often referred to today as a “lockstep-to-levels” or performance-based system.

In fact, a number of large international firms have recently put such systems in place, and an even larger number have committed to introducing such systems in 2010. While these performance-based systems are relatively new to large firms, their use is well proven among midsize and smaller firms for more than a decade. The experiences and challenges these firms have encountered in their movement to merit compensation offer lessons that can help others in implementing performance-based systems. In this article, we will cover some of the common problems, and innovative solutions, that can help guide any firm thinking about making this same transition.

Like the large firms now contemplating a switch, many firms began shifting away from lockstep primarily for economic reasons. While in prior years it was a response to the salary wars, now it is a broader realization that the economics of the profession have changed, and a more flexible structure that works in both good and bad economic times makes more sense. Still other firms changed their systems in response to growing client concerns about the cost and value of associates – a cost which is largely driven by compensation, and value (or lack thereof) which is exacerbated by the rapid rise in billing rates, the lack of practical experience in law school, and the widely varying training and development efforts within law firms.

Before addressing how to make this transition it is first helpful to clarify what is prompting firms to switch away from traditional lockstep systems:

- Lockstep worked well for much of the modern history of the legal profession, when most firms significantly increased profits every year and a major challenge in running a firm was just in finding enough qualified people to do the work. But implicit in a lockstep system is that it implies both a raise and a step promotion each year, based largely on acceptable performance and the passage of time. It was this “presumed progression” that created the problem. Those systems failed to control costs for clients when value was not increasing proportionately, and failed to manage the careers/salaries/billing rates of simply average performing associates. The result for most firms was the over-promotion of at least some associates and an ever accelerating salary commitment. For many firms, the only real merit element in their system was its pass/fail standards, and few failed in a sellers' market. In these firms, the idea that an associate might be held back a class year in both compensation and standing was nothing more than a clear indication to find another job.

- The recession in the business/legal markets has strained the economics of law firms and many are now searching for ways to control costs. The single greatest cost category in law firms is typically the cost of professional personnel. What is different now is that firms are facing the prospect of little or no growth in billing rates, while at the same time they find that they have more lawyers than work.

- As noted earlier, growing pressures from clients are likewise motivating law firms to consider changes in their lockstep structure. Clients have long expressed concerns about the value of inexperienced associates charged out at high billing rates. A performance-based system generally links rate increases for associates to their performance (and therefore, value).

- There is at least one other motive that is prompting firms to consider some alternative: As clients and some law firm leaders have long noticed, lockstep promotion and compensation has almost completely disappeared in most other professions. While it may have been a viable approach in a sellers' market with constantly growing profits, it isn't realistic to expect that the economy for law firms will always grow, or even grow at historic rates. Interestingly, the most common use of lockstep compensation and promotion is either in government or in other businesses among commodity level employees who, at least in theory, can be replaced easily. Among professional service firms, lockstep has largely been replaced with a system that is only lockstep for one or two years, but thereafter progression and compensation are based entirely on individual merit.

So what have more than ten years of experience helping law firms with associate merit compensation and progression systems taught us? What are the common problems that law firms have encountered in developing and implementing these systems from which we have learned the most? How do these systems typically evolve? If your firm is thinking about making this transition, how can you avoid the problems and costly financial mistakes experienced by those who went before you?

There are innumerable variations on merit compensation systems. However, for ease of discussion here these will be divided into two broad categories:

- Lockstep With Merit Compensation Elements (such as merit bonuses), and
- Performance-based System (encompassing all elements of compensation and progression), also referred to as a "Levels" system by some firms.

Many firms sought a short-cut in transitioning to a performance-based system by maintaining some version of their historic lockstep structure, and then just topping it off with a merit-based bonus system that was supposed to differentiate among associates. The problem is that this approach still has most of the flaws and few of the benefits of a performance-based system:

- Progression, both in career standing and in base compensation, is still based on time and simply acceptable performance rather than measured evaluations of actual performance.

- Many of the firms that went to this system found that they had to constantly adjust the system (rather than just the placement of people within the system) to get any real benefit.
- To be truly flexible enough to accommodate the variety of performance contributions by associates, base compensation had to be severely limited, and associates were often left waiting and wondering if or how much they would get in a bonus. As a result, there was a high degree of uncertainty among associates, and most such systems produced higher than normal levels of turnover, most importantly among the most valued associates.

For the most part, lockstep compensation systems with merit bonuses have failed to achieve the benefits of true performance-based systems.

Performance-based systems promote or hold associates based on a careful determination of associate's mastery of specific competencies as they relate to the firm's needs. Automatic progression is not assumed, and it is not unusual for a star Associate who is three years out of law school to be paid more in base and bonus than an average performing Associate in their fourth or fifth year. Performance-based systems routinely communicate and reinforce that associates will progress and be paid at different rates.

Many firms assumed this would be an easy system to create; after all, the majority of law firms in the United States use some form of merit based compensation for their partners. They assumed it would be easy to replicate the concepts and apply them to associates. Unfortunately, the significant training and development needs of associates, the importance of feedback and coaching to their development, and the de facto dependence of associates on partners for work and mentoring quickly revealed the flaws of that assumption. And the truth is, most partner compensation systems provide little more than superficial feedback or guidance to the partners, and largely just exist as a grading system for compensation.

**Common Problems in Design and Implementation**

Designing an effective performance-based system for associates touches numerous areas of the firm. We will not cover all of the challenges encountered but will highlight some of the most common and troubling problems law firms face when making changes to a lockstep system.

**1. Lockstep by a Different Name**

One of the most common problems is when a firm announces a change to a performance-based system, but then fails to consider and implement all of the required changes in structure, partner behavior and process. The net result is that the system still works largely like the old lockstep system – evaluations rarely result in significant differentiation among associates in either standing or compensation, few difficult personnel decisions are made, little is done in the way of coaching or helping associates to develop, most associates continue to progress in the same class groupings in which they started, progress still occurs on an annual basis – and the firm realizes that it went through the disruption of an announcement but failed to get most of the promised benefits. The real issue is often that the firm failed to pay attention to the most important element in a performance-based system: methodical, constructive evaluations.

## 2. Lack of Methodical, Constructive Evaluations

We frequently hear from associates that partners are not effective in providing feedback. This was well documented in the 2007 report published by Hildebrandt entitled Understanding Associates, which was based on surveys sent to over 10,000 associates. Two of the most common complaints from associates are that partners mainly fall into two categories:

- Those that rarely give clear or constructive criticism directly so the result is that every Associate gets an A or an A minus at worst (regardless of the partners' frustrations with or concerns about the associates), or
- Those that eviscerate associates without providing any constructive comments or helping them to overcome their weaknesses.

In response, firms have tried a number of approaches:

- They shorten the evaluation form to make it easier for partners to give input. Or, they lengthen the evaluation form to get "more detailed information."
- They put the evaluation form online in the hope that technology will improve the quality of the evaluations.
- They eliminate the grading system. Or, they create a more detailed grading system.
- They implement training programs for partners in how to conduct evaluations, though most programs have not been effective.

The most fundamental problems are that many lawyers do not like giving or receiving criticism to/from their peers, and second, that there is only a small percentage of the partner population that is highly skilled at assessing performance and then delivering constructive feedback that is effective.

One of the most critical elements of a performance-based system is a high quality evaluation system. This means the evaluations should meet the following criteria:

- Meaningful,
- Consistent across evaluators,
- Constructive,
- Fair,
- Accurate, and
- Objective.

If there are significant differences in how partners evaluate associates, the performance basis of the system will have no integrity and it will lose credibility with both partners and associates alike.

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### 3. Promotion Criteria Developed by Each Practice

Many law firms have compensation criteria that are supposed to describe the skills and characteristics each partner should display. Theoretically, the more of those qualities a partner has, the more he/she will be rewarded with compensation. Firms switching to merit systems for associates often apply the same concept. In many firms, the initial effort to identify these desired characteristics is simply based on a collective brainstorm by partners about the qualities of a theoretical ideal associate. Unfortunately, these criteria often ended up sounding more like the Boy Scout's Creed (no offense to the Boy Scouts intended), and occasionally resulted in associates qualifying for promotion that either lacked technical skills, or worse, lacked the personality and maturity to become a desirable member of the firm.

The second attempt is often a set of criteria developed by each practice area ("Associates progressing from level X to level Y must have conducted four depositions in a securities case"). However, practice area-based criteria quickly reveal a number of problems as well. One problem is that the criteria for promotion vary dramatically among practice groups. Second, even associates who have mastered certain technical skills may not be sought after or valued by clients, or for other internal reasons may not deserve a promotion.

All of these experiences prompted many firms to wonder: Can you define universal criteria that apply to the individual but simultaneously help the firm, that span all practices, and that can still be implemented on some practical basis? The answer is clearly yes—what's needed is a combination of behavioral competencies combined with technical competencies, which will be described in more detail below.

### 4. Hours Or Profits Become The Sole Criteria

Law firms have long used associate bonus systems that were based entirely, or primarily, on billable hours. The more hours an associate billed, the higher the bonus. With the advent of merit compensation systems, some firms quickly fell into old habits whereby billable hours either consciously or unconsciously became the determining factor in promotion and compensation advancement. A few firms even went so far as calculating profits generated by each associate, and used that as the sole determining factor of "merit."

Experience has shown that a purely billings-based criterion for measuring performance has at least two shortcomings. In the short term, it produces high profits and intense internal competition. Over the long term, it produces less of a firm and more of a group of sole practitioners, whose motivation is their own short term profitability at the expense of building long term skills or building the firm. It also does not help associates create an "owner" mentality because they are rewarded primarily on hours or profits, rather than on a more subjective, total-contribution basis like partners are. Firms that transition to performance-based systems typically learn, after two to four years, that there are some associates (not to mention partners) who are highly profitable but who erode the institution and should not become owners.

### 5. Too Many Levels

In initially designing a performance-based system, an obvious question is, how many different levels of associates should we have? Many firms discovered a painful lesson when they tried to quickly design a transition from their eight or more associate levels under lockstep to an equal number of levels under merit. The challenge is that each level typically needs its own criteria, because associates want to know what they need to do to progress from one level to another. Developing eight or more distinct sets of criteria quickly reveals insignificant differences among levels that result in contradictions and conflicts in the evaluation process. Experience has shown that three to four levels work far better, as firms can establish specific and clearly differentiated criteria for each level.

**6. Internal Value vs. External Value Reflected in Billing Rates**

One of the more subtle challenges firms have encountered concerns the billing rates of associates under a performance-based system. While it is generally true that associates advancing through the system should likewise receive an increase in billing rate (to the extent consistent with the market), it is often overlooked that some associates may improve their value to the client while failing to improve their long term value to the firm. The most important lesson we can offer here is a simple one. Billing rates should reflect, first and foremost, how clients perceive the value of the individual, not how the firm perceives value, or how popular someone is within the firm. Law firms should be careful not to let egos get in the way of judging billing rates, especially when someone isn't perceived "as good" internally, yet may be popular externally with clients. The more challenging part of this problem is this: Can a law firm have an associate who continues to progress in compensation due to increasing profitability, without progressing in internal standing?

**Enough with the Problems – What about the Solutions?**

When firms implement a performance-based system, they often discover that the new system has a significant impact on their existing infrastructure systems. This, in turn, requires significant behavioral change among partners and associates. While we can't address all of the solutions here, we can touch on two of the most important: Clear Expectations for Progression (on what basis will performance be measured for each level) and Evaluations.

**Behavioral and Technical Criteria for Advancement**

As noted above, many firms discovered the importance of clearly defined criteria to manage expectations about promotion and advancement, as well as to ensure consistency in conducting evaluations. But how does one develop good criteria?
A number of firms have discovered the benefit of using a two-layered approach, consisting of both behavioral competencies and technical competencies.

**Behavioral Competencies**: Behavioral competencies are observable and measurable behaviors, knowledge, skills, abilities, and other characteristics that contribute to individual success in the organization (e.g., teamwork and cooperation, communication, listening, abstract reasoning, synthesizing disparate information, etc.). Behavioral competencies have proven to be among the most successful means in battling sole practitioner/silo behavior, by defining a firm-oriented system of performance assessment. These tend to be broader than the technical competencies which are more specific to a practice area or to the practice of law generally (such as drafting certain types of documents or legal writing skills).

**Technical Competencies or Criteria**: Behavioral competencies alone do not determine advancement. Many firms use a second layer of technical skills as a gateway in determining advancement. Technical criteria are often defined by the leadership of one's practice, and then assessed based on one's performance under the supervision of partners within that practice.

One of the challenges many firms have discovered in transitioning to a performance-based system is that some associates advance quickly in their technical skills, but fail in terms of behavioral skills. Fortunately, this is only a minority of associates, but it does create an interesting structural question: Will your system allow someone to be highly paid, yet not advance within the firm's structure? Increasingly the answer is yes.

**Effective Evaluations**

As noted previously, one of the most challenging aspects of any performance-based system is how you perform effective evaluations. More importantly, how do you overcome the fact that many partners aren't well suited to this function? There are a number of potential solutions, but one that has shown tremendous success over the long term relies on two simple facts: One, that most partners are not well suited to doing constructive evaluations, and two, that most partners cannot help but express their true feelings if they verbally describe an issue to a third party.

The solution has been for firms to transition away from partners filling out evaluation forms, to partners being interviewed by professionals who are skilled at soliciting feedback, drafting constructive evaluations, and conducting in-person evaluations. These professionals, who come from a wide variety of backgrounds, interview every partner in the firm and lead/assist in the evaluation sessions with each associate (often accompanied by a partner who has significant experience with the associate).

Firms that first experimented with this approach made some surprising discoveries:

- Associates commented that the quality of evaluations, and the volume of specific, constructive feedback was greatly improved.
- Associates liked the fact that an independent party was participating in the interview.
- Associates commented that the feedback they were receiving was clearer, more focused, and therefore far more helpful in understanding how to advance within the firm.
- To their surprise, firms discovered that partners spent less time on the evaluation process (at least, for those partners who had actually spent time previously completing the evaluation forms).
- Participation in the evaluation process approached 100%...no one was overlooked, no one received superficial feedback, and partners seemed to find the process much easier.
- By appointing trained professionals to conduct the evaluations, there was now someone appointed to look at follow up training, feedback, coaching, guidance, etc.

Switching to a performance-based compensation and promotion system isn't quite as simple as many firms first imagine, but the results can be well worthwhile if the program is carefully designed and implemented. We haven't addressed the other question in such systems: What does the compensation structure look like? We will address that topic in the next article in this series.

One final question: We started this article by saying that economics are clearly driving much of the interest in performance-based systems. So, does such a program ultimately save the firm money? Among firms that have had the program for a long period of time, they clearly believe that it does by better matching skills to compensation, and by forcing the realization that every lawyer does not need to be on a partnership track in order to do meaningful and valuable work for a client. But more importantly, among firms with successful programs, they report the process has produced added benefits beyond the hard dollar cost savings. They have significantly improved the quality and capabilities of associates, cut down on unexpected turnover, and improved associate morale.

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