



Shannon & Manch LLP

# Merit-based Compensation Systems

## *Trends and Implications*

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### Introduction

Lockstep has been the preferred compensation model for large law firms from the 1980's. The recent economic crisis spurred interest in alternatives to seniority-based compensation models. In July of 2009, the National Association for Law Placement and the Professional Development Consortium conducted a survey of their membership on interest levels in variable compensation<sup>1</sup>. The results showed that interest in moving away from lockstep was growing. Among the firms that appear among the AmLaw 100 who responded to the survey, 45% currently have pure lockstep compensation – but among them, 77% are considering a move to variable compensation. There are many reasons for the interest in merit-based compensation systems, not the least of which is the cost of associate salaries and the fact that clients rebel against paying high rates for working with untrained talent. There have also been consistent increases in technology and overhead costs, as well as pressure to maintain competitive client fee structures<sup>2</sup>.

Until now, firms have moved slowly into the realm of merit-based compensation, for the most part preferring to maintain a lockstep approach to salary and applying merit assessments to bonus decisions in order to reward differing levels of achievement.

A 2001 **American Lawyer** survey reported that legal and other staff costs account for a minimum of 45% of law firm expenses.<sup>3</sup> It seems then only prudent for firms to examine new ways of compensating associates with an eye toward receiving the greatest benefit from monies spent. Firms want to cut costs while safeguarding their ability to respond to market increases in salaries or demands for legal services. When the economy fluctuates,

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<sup>1</sup> Needs citation

<sup>2</sup> Compensation Plans for Law Firms, Second Edition, Cotterman, James D., ABA Law Practice Management Publications, 1995.

<sup>3</sup> The AmLaw 100 Annual Survey, *The American Lawyer*, 2001.

associate salaries typically do not. Firms do not lower pay rates when revenues and profits decrease. They may adjust bonus payouts, but lockstep compensation policies in particular limit the flexibility to control staffing costs. In an economic downturn, when natural associate attrition decreases, this can have a negative impact on firm staffing costs. It may also precipitate associate layoffs when staffing costs become overly burdensome.

Yet, what works in the corporate world or even systems that seem logical may not be appropriate in an environment in which the intellectual capacity of the lawyers is the greatest asset of the enterprise. Care must be taken that any system adopted supports the development and retention of the firm's most critical resource—its developing lawyers. Compensation policies that reward individual performance offer an alternative to firms considering changes in their salary structures.

## **Lockstep vs. Merit-based Compensation**

### **Lockstep Compensation Systems**

The most frequently cited reason for paying each class the same base salary is the development and preservation of collegiality among associates believed to result from a noncompetitive reward system. Achievement-oriented individuals who excelled in academia are presumed likely to apply that same level of determination to their success in a firm. Law firm partners believe firms need to remunerate each class of associates equally in order to avoid competitive behavior that would be counter to firm culture. Another reason firms use a lockstep approach is because of the perceived difficulty determining relative value among and potential long-term contributions of junior associates. Partners also note that the skills and behaviors that would be highly rewarded in an associate's early years might not be the same qualities needed to excel as a more senior associate or partner candidate. Rewarding entry-level lawyers for merit-based criteria might therefore stifle their long-term potential by reinforcing behaviors that are only useful in the short-term.

One of the most powerful reasons for employing a lockstep system is that it is easy to do so. It requires no consideration of the individual attributes or performance of an associate and it can be administered with the press of one key, as associates are automatically advanced to the next class pay level at year-end. Finally, associates say they like lockstep systems because they do not have to wonder if they are making the same amount of money as their peers. They like the comfort level of not having to compete with their friends and colleagues.

To summarize the advantages of lockstep:

- All members of a class are compensated equally, relieving them of a need to compete with their class members in order to be rewarded
- Firms do not have to critically assess individual progress or contributions early in a lawyer's career
- The system is simple to administer

- Associates like it

The disadvantages are suggested, in part, by the advantages. A lack of a need to compete may also dull motivation to achieve. There are very few environments in the working world where employees are considered equal based only on their seniority. It can create an unrealistic set of expectations for new associates that must then be broken down if they hope to succeed later as partners. Case in point: it is the rare firm today that employs seniority-based compensation systems for its shareholders. By relieving the firm of a need to assess progress or contribution, lockstep systems also unwittingly create an environment in which poor performers are rewarded in the same manner as high potentials. If associates' performance is not carefully appraised in the earliest stages of their careers, it becomes more likely that weaknesses will not be identified and strengths will not be reinforced.

The system's ease of application may not offset the costs accrued when those who fail to contribute adequately are paid at the same level as those whose contributions drive firm revenues. Finally, associates like the system because it does not require them to work any harder than any of their peers, and if they choose to work less they know they will make the same amount of money. Ironically, the associates most likely to find the system less than appealing are those who work the hardest, whose desks overflow with assignments, and to whom the partners go to first with their most challenging assignments.

The greatest strength of the lockstep system may be experienced in an associate's first two years with a large law firm. By affording equal pay to all within the most inexperienced classes, the firm sends a powerful message that skill and knowledge development are more critical than relative performance. The firm may also be building a foundation for long-term benefit through the collegiality nurtured within a lockstep program. These junior associates should learn to work together in a cohesive and collaborative manner if the system functions as it should. However, experience shows that this last benefit exists only during times of normal workload. When the workload increases, equal pay for unequal effort becomes an issue that can create extreme divisiveness and distrust among associates regardless of existing cultural bonds. Recent increases in lateral hiring also suggest this argument may be less persuasive. With typical associate turnover of 19 % or more annually<sup>4</sup>, the bonds among members of the associate population are likely to be strained by more than compensation systems.

### **Merit-based Compensation Systems**

There are numerous variations of merit-based compensation systems, but all have in common a regular assessment of individual progress and contribution. As associate salaries increase, firms search for ways to augment and adjust existing lockstep gradations with performance objectives that allow for merit determinations. Some set billable hours thresholds tied to distinct pay levels, creating two tiers within a standard lockstep pay level<sup>5</sup>. These systems allow associates to choose whether they want the

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<sup>4</sup> *Update on Associate Attrition*, The NALP Foundation, 2006.

<sup>5</sup> "Such a Deal: Does Perkins Coie Have the Best Time-Money Solution?", ABA Journal, October 2007.

higher salary tied to the market in exchange for increased billable targets or whether they prefer to work less for less money. Many firms who award bonuses based on merit find the leap to a merit-based salary system is not as great as they might have thought.<sup>6</sup> They find the tools to implement a merit pay system already exist within the firm's performance appraisal system. Objectives firms hope to meet by implementing a new compensation structure often begin with a need to control costs. But there are other benefits to employing a system that recognizes and rewards individual effort.

The strengths of merit-based compensation systems are as follows:

- Ability to motivate individuals to do their best
- Ability to reward top performers without doing the same for poor or non-performing lawyers
- Overall flexibility afforded to both the firm (in how and what they reward) and individual lawyers (in goal-setting and developmental planning)
- The fact that they provide a framework through which developing associates learn valuable information regarding their progress, strengths, and weaknesses relative to their peers.

Recognizing and rewarding individual effort enhances motivation by allowing achievement-oriented individuals to understand what the firm values—and expects by seeing what is rewarded. Most associates, though seemingly attached to the lockstep approach for obvious reasons, are desperate to know where they stand in the eyes of the partners. Having the firm outline expectations and performance objectives and letting each associate know that these are the criteria upon which he or she will be evaluated can be highly motivating. Not only do they know what the firm wants, they know that supervising lawyers have a set of performance standards guiding their evaluations. An individual's motivation to achieve is directly related to and affected by both his/her *desire* to succeed and his/her *expectancy* of success.<sup>7</sup> Merit-based compensation approaches provide a direct reward for success that builds individual desire to achieve, while clear expectations and fairly applied standards make associates feel as though they have a better chance for success.

Merit pay also provides firms with flexibility. It allows for salary differentials that take into consideration variations in billing rates, profitability of different practice areas, and current market demand for legal services—in general or a specific practice specialty, as well as hours billed and realized. It recognizes that associates may develop at different paces and still be contributing in a significant way. In addition to these advantages to the firm, the individual associate may benefit as well. For example, individuals who wish to go on flexible or reduced work schedules or those who want to speed ahead may do so if the firm believes they are making a worthwhile contribution. There is no need to worry about the rest of that person's "class" or how meeting his or her needs may create inequities for others under a lockstep pay program. Firms also have the ability to lower

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<sup>6</sup> "The Next Pay Revolution," Koppel, Nathan, *The American Lawyer*, February 13, 2001.

<sup>7</sup> Weiner, Bernard, Theories of Motivation: From Mechanism to Cognition, Rand McNally Publishing, Chicago, 1973.

staffing costs in times of low demand or in practice areas with low profitability, possibly staving off layoffs of associates.

Finally, tying the compensation system directly to performance assessment allows the firm to focus on a comprehensive approach to lawyer development and effectively integrate compensation and development systems. When the firm identifies core competencies or the skills, behaviors, and personal attributes that are most valued and measures associate performance against those standards, developing lawyers will have the best chance possible to achieve their potential and succeed in the firm. Salary is the greater part of an associate compensation benefit. The ability to tie pay level and increases to skill development, exhibiting behaviors consistent with the firm culture and business objectives, and the presence of personal attributes that are common among the firm's most successful lawyers provides a meaningful use of the compensation system. It also results in a more equitable distribution of the firm's overall resources.

There are also disadvantages to merit-based pay systems. The first, and perhaps most critical, is that these systems are perceived as highly unique among law firms. A firm choosing to adopt a non-traditional compensation system risks outsider speculation that there are money problems. Law firm management has traditionally been slow to adopt new ways of doing things while sometimes being quick to condemn any practice that is new or different. This suggests that those firms who stake out a position with a purely merit-based approach may be out there on their own for some time before their peers follow. This could create a recruiting disadvantage in the short-term. Another disadvantage of these systems is that to be successfully applied, they require that the firm have clear performance expectations and standards, an effective method of performance appraisal, and a means to assist those with developmental deficiencies. These three things can be a tall order for many firms.

There is also the associate population to consider. Associates are skeptical of compensation changes and particularly suspicious of systems applying subjective criteria and depending on supervising lawyers' feedback. Most have experienced a wide variance in the quality of supervision they have received and the consistency with which their performance has been evaluated. Associates may also be concerned that the system will take them back to law school days when the most competitive, high-achievers in their classes were vying for the top honors. Many new associates remember this as an extremely negative experience and say they imagine this will happen if lockstep pay is eliminated. It is true, however, that high performing associates the firm is desperate to retain can be compensated significantly above their current lockstep levels which may convince them to stay, or at least stay longer.

In summary, the best aspect of a merit-based compensation system is that it gives the firm freedom to make practical, developmental, and realistic decisions regarding associates' salaries. Because it is not widely accepted among law firms, it is an "unknown" and most fear change. The realities of implementation have been far less dramatic. Firms who have adopted this type of system do not appear to have experienced substantial changes in their culture or in their ability to recruit and retain good people.

## Considerations for Adjusting a Compensation System

There are five key questions to consider when deciding whether to make a change in the firm's compensation system. They are as follows:

### 1. What are the firm's objectives in making the change?

It is important to identify the specific objectives the firm hopes to attain by changing the compensation pattern. Recognizing that much time and energy will be spent implementing the changes, the firm needs to consider what it will gain by doing so. It may provide some economic gain and a strategic advantage in future staffing decisions, but it may also yield advantages such as lawyer career flexibility, enhanced motivation, more targeted professional development planning, a better understanding among associates of what it takes to become successful at the firm, and the development and utilization of a comprehensive approach to lawyer development. Typical goals for a law firm compensation system include the following:

- To allow the firm to develop and carry sufficient legal staff to meet client needs during the best and worst economic conditions
- To maximize profitability and productivity of every firm lawyer
- To reward top performers

### 2. What are the market parameters within which the system has to operate?

No compensation system can be designed in a vacuum. There must be a realistic assessment of market salaries and the minimum pay rate necessary to attract and maintain the highest caliber of lawyers at each level of seniority. The good news is that a merit-based system allows for greater flexibility than lockstep when it comes to hiring laterals. The bad news is that today entry-level salaries are generally fixed in each geographic market and variations may be seen as indications of firm financial instability. The firm needs to know the top and bottom figures for all levels of associate ranks in each city in which it has offices.

### 3. Who will administer the system?

For the system to achieve all its goals, participants must have trust in the individuals who are administering the salary decision-making process. The firm will need to determine whether a new or existing committee will oversee the process or whether an administrator will be assigned to this responsibility. Determining who would be chosen to administer the process may help the firm to decide if this is the right path to follow.

### 4. What obstacles are expected to arise in the implementation of such a system?

Every firm is unique and it is always difficult to predict how people will respond to a change in compensation policy. It is useful to try to identify where the problems might arise and plan to counteract them. Critical problems may arise if the firm's evaluation system has not been applied in a consistent or fair manner in the past, leading associates to be concerned that a thoughtless or tardy review will negatively impact their salaries. Most of the typical obstacles can be offset by an effective information campaign that

provides everyone with a clear understanding of how the system will work and the safeguards that are in place.

**5. Will the benefits achieved offset any negative impact that may result from the changes?**

Any time an employer discusses changing the organization’s pay structure, employees will be anxious to learn how it will affect what they are paid. Change is frightening because it represents a potential risk. Even if the firm is adopting a plan that might substantially increase salaries, firm leaders can expect some level of stress among the associates until the system is completely understood. It is important to be able to assess the value of the planned changes to the system as it relates to the relative level of stress and anxiety it will produce among the associate body.

**Trends in merit-based Compensation Systems**

Most major consulting firms base their pay structure on performance, and among corporations, 44% of executive level pay is performance-based.<sup>8</sup> There are signs that many more law firms are considering a further shift away from lockstep. As the total cost of lawyer compensation continues to rise for firms—in many cases far above market rates in many geographic locations—firms may have no choice but to explore alternative approaches. For example, a recent **Legal Times** article posted this salary comparison chart based on geographic cost of living<sup>9</sup>.

**Equivalent of earning \$160,000 in New York**

Boston	\$ 240,397
Chicago	278,573
Houston	370,462
Los Angeles	205,631
Miami	288,696
San Francisco	190,789
Washington, DC	234,757

**Measuring Performance to Make Merit-based Assessments**

Most law firms use a combination of measurable and subjective criteria to evaluate associate performance. Examples of criteria used are as follows:

**Measurable Criteria**

Hours billed

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<sup>8</sup> “January 2000—Four Studies Track What Alternative Pay Plans Work Best,” The Institute of Management and Administration’s Annual Salary Survey, January 2000.

<sup>9</sup> “Washington Firms Assess the Price of Staying Top Tier,” Legal Times, October 1, 2007.

Percent of time written off or uncollected  
Total hours  
*Pro bono* hours  
Billing rate  
Committee/firm activity hours or professional memberships  
Business origination/referral of business  
Articles published  
Presentations given

### **Subjective Criteria**

Technical expertise  
Experience/skill/knowledge as compared to a standard set of core competencies  
Quality of work  
Attitude/approach to work  
Commitment  
Firm citizenship  
Supervisory/matter management skills  
Mentoring/training others more junior  
Client satisfaction

Most firms place the highest value on the measurable criteria, with those factors accounting for up to eighty percent of the final compensation level determination. Yet supervisory assessment of lawyer performance is still important in the majority of systems. Most firms use their performance appraisal process to provide some or all of the information that will be used in compensation decisions. Firms use annual, semi-annual, and/or post-engagement assessments to gather both measurable and subjective information on each associate. Typically some type of relative ranking is done at the practice group level, but most firms have centralized review with final decision-making authority for all compensation decisions for associates. This provides consistency and fairness across practice specialties and offices.

### **Implementation Strategies**

Changing the structure of associate compensation is a major undertaking and must be pursued carefully. In a comprehensive discussion of compensation systems, the American Bar Association lays out sensible rules for adjusting pay plans.<sup>10</sup> The rules they suggest are as follows:

1. Everyone has to understand the system
2. The system must have some relationship to what individuals contribute to the firm
3. The rules must be clear
4. The rules must be followed and applied consistently, from person to person, from year to year
5. The “Compensators” must be trusted

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<sup>10</sup> Compensation Plans for Law Firms, Second Edition, Cotterman, James D., Editor, ABA Law Practice Management Section Publishing, 1995.

6. The benefits of the system must outweigh the additional complexity

Though straightforward and practical, these are rules that most firms find hard to follow. In order to implement a merit-based compensation system, the firm will need to plan how well it can follow each of these rules.

### **Creating Understanding**

The system needs to be described in writing and should also be communicated orally to firm members in forums in which there is an opportunity for question and answer. Everyone should have sufficient time to study the system and have his or her questions answered before the system is applied for the first time. Sometimes it makes sense to create a committee of representative associates who will be involved in some aspects of the decision-making. Some firms use a group such as this as a sounding board for various aspects of the plan to test associate **and** partner reactions.

### **Relationship to Contribution**

For the compensation plan to have a meaningful relationship to individual contribution, the firm must be confident that it has the means to fairly measure each person's contribution. Whether through the use of an effective evaluation process, a reliable accounting of measurable data, or some combination of the two, merit-based systems are dependent on a reliable, accurate flow of information on every lawyer.

### **Clear Rules**

*"The simpler the better"* is probably a good philosophy to follow when designing pay plans. If the system is too complicated, no one will understand it and associates will assume its complexity is a cover for paying them less. A system with only a few rules allows for fewer exceptions. Some of the most effective systems pare down the criteria for measurement to four or five key factors. Rules for their application to each individual's performance are simple and practical. Making exceptions to the rules governing compensation is the fastest way to undermine any system in use.

### **Applying the Rules Fairly and Consistently**

The greatest fear in a wholly merit-based system is that pay will be determined based solely on how a partner *feels* about an associate at the moment he or she is writing reviews or offering feedback to decision-makers. Associates fear retribution for turning down assignments, poor marks for missteps that were the result of inexperience rather than indicative of their capability, assessments based on personality or likeability rather than legal skills, favoritism for individuals who belong to an *"in crowd,"* and a lack of meaningful information on which to make decisions due to partners too busy to offer feedback.

These are critical factors to consider because any or all of these influences could have an impact on compensation decisions in a merit-based compensation system. Partners would need to be alerted to the importance of their full commitment to fair and consistent assessments for all lawyers under their supervision. There would also need to be firm-wide oversight to ensure fairness and consistency across offices and practices.

### **Having Trusted Compensators**

Beyond trusting their own evaluators, associates will need to be able to trust members of the associate compensation committee who will be responsible for overseeing the process and making final decisions. Some of this trust will flow from associates' level of understanding of and comfort level with the plan itself. Some of it will flow from their trust in the individuals who appraise their performance currently. Their trust will need to be earned over time with the successful, unbiased application of the plan year after year.

### **Benefits Outweighing Complexity**

Firms must judge whether this type of system would work in their work environment and culture and what benefits might result. Only then can a decision be made to move to a merit-based compensation system.

### **Summary and Action Plan**

This report contains the critical information for consideration in making decisions on compensation plans. An actual action plan to implement a change such as this would include the following ten steps:

1. Convene a committee of firm leaders to consider the core questions and assess the benefits of making a change
2. Assess the level of support for merit-based compensation among practice group and office leaders
3. Choose a group of associates to involve in the planning process
4. If you have not done so already, identify core competencies for associate performance
5. Develop the range of criteria that will be applied in compensation decisions
6. Assess the quality of the firm's current information gathering processes on associate performance
7. Address any weaknesses in those systems and train supervisors in effective evaluation techniques
8. Develop rules for the decision-making process and put them in writing
9. Plan a timeline for rolling out the new system, allowing plenty of time for education and training
10. Identify a process for making adjustments to the system over time

**Shannon & Manch** consultants can assist you in every element of your strategic planning and program implementation. We have helped numerous firms move away from lockstep compensation and bonuses and would welcome the opportunity to help your firm determine if this step makes sense. Contact **Sue Manch** at 202-293-8900 or [manch@shannonandmanch.com](mailto:manch@shannonandmanch.com) for a free consultation and discussion of possible approaches.

