Do Financial Incentives Work in Law Firms?

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Incentives are complex and, according to Wikipedia, omnipotent: "*The study of incentive structures is central to the study of all economic activities (both in terms of individual decision making and in terms of co-operation and competition within a large institutional structure).*

In Australia we are currently conducting a Royal Commission into the banking sector. The Commissioner is yet to report formally but the media are reporting widespread inappropriate behaviour in lending practices and in financial planning advice. Allegations of conflict of interest, dishonest conduct and poor corporate governance have set heads rolling – very senior, experienced heads (with more blood on the carpet pending, we are assured). What has caused all of this mayhem in hitherto highly regarded institutions? It is alleged that the root cause, now squarely in the spotlight, is – you guessed it – incentives.

It would seem that the incentive practices within our largest banks and financial-advice firms have enriched a few but created a massive trust deficit among the many.

The volume has certainly been turned up on conversations around corporate social responsibility and the social license to operate.

All of this reporting has got me wondering: Where is the legal profession at on the phenomenon of incentives? Do incentives really work in a law firm? If so, for whom? What form should incentives take? Is it actually possible to structure incentives that benefit the individual lawyer, the firm and the client simultaneously? I don't pretend to have watertight answers to all of these questions but, as is the fashion, "Let's start a conversation".

Incentives take many forms in professional service firms; let's carve out those that are intrinsic to the work itself – ones that help people and organisations, lead to happy clients, offer professional challenges, win every now and then, right wrongs… that sort of thing. Extrinsic incentives – financial rewards, time off, new toys: that's the murky water that I would like to jump into.

In management, specifically in this case human-resource management, I think that we sometimes hold certain phenomena as axiomatic truths: "If we do this, that will happen", without doubt, beyond question. The belief that "financial incentives *WILL* change behaviour" fits into this category. This is the assumption that underpins any form of contingent-based compensation, be it partner or staff. If financial incentives prove so reliable in getting people to do what we want, why do they fail to change behaviour and performance in many law firms?

Employees for now, partners when we next correspond

I am talking here of financial incentives other than, and in addition to, fair-market salaries. Of course, different firms do financial incentives differently. Some determine an annual 'capacity' budget and offer a payment for fees rendered in excess of the budget. Some pay an incentive on every dollar billed. Some pay an incentive for billings beyond break even. Most firms, in my experience, don't mess with incentives, preferring to negotiate a fair-market salary annually, paid monthly regardless of performance.

Oddly enough, those who do structure a financial incentive into the firm's remuneration approach seem to do little to link the incentive program to their strategic objectives, beyond fees billed and profit. I have no doubt that there are exceptions but in my experience they are few.

I can count on one hand the firms that I have encountered in nearly 30 years who provide a financial incentive based on measured client satisfaction, or for exceeding client expectations, or for assisting others in their learning and development, or for developing new service offerings, or – heaven forbid – getting a great client outcome well under budget. One could argue that the prospect of partnership is an all-encompassing incentive aligned to firm strategy, but that's drawing a pretty long bow.

I can see several problems with employee-lawyer financial incentives. Firstly, expecting someone to respond positively to an incentive that is contingent upon forces beyond their control will probably lead to disappointment. Most employees that I encounter seem to be of the view that the amount of work they do and the fees they recover are determined, in very large part, by the amount and quality of work that they are delegated by partners. Most will not or cannot source their own work, so the inference in the incentive is not to produce more (that's beyond their control) but not to shirk. This should not require a contingent reward: this is their job. We are paying for this already.

The situation is different for senior non-partner lawyers with their own practice following. A meaningful financial incentive can instil a sense of equity participation from their client development activity and hard work, and it's in their best interest not to over-service matters and to delight clients. Thumbs up all round, I'd say!

Secondly, a question: Are we, the employers, seeking to mitigate risk or to provide motivation to excel? As senior lawyer salaries climbed significantly around 2005 (remember the 'talent crisis'?), emboldened by the search and placement industry, employed lawyers seemed to abandon thoughts of a direct correlation existing between pay and performance, instead viewing their 'worth' to be determined by externalities beyond the control of the firm (i.e., 'A person with my level of experience is worth…). When the world economy tanked towards the end of 2017, firms moved to mitigate the risk of paying high 'perceived worth' salaries for uncertain performance outcomes. We sought to meet pay expectations by providing more affordable base salaries topped up with bonuses once performance expectations were reached, effectively shifting the risk of uncertainty onto the employee. Most didn't make targets. The problem here lies in the nature of motivation. Is it possible to motivate someone to excel by paying them what they perceive to be their market worth, or is that considered to be a basic right? I don't know, but I do know it didn't work. Lawyer and law-firm performance were largely unaffected, and employee attrition increased.

Thirdly, our relationship with money is changing. This week the Australian media reported on a recent survey of millennial employees. "*The Deloitte survey found Millennials believe business priorities should include job creation, innovation, enhancing employees' lives and careers and making a positive impact on the environment. When asked what the organisations they worked for focused on Millennials cited generating profit, driving efficiencies and producing and selling goods and services, the three areas they felt should have the least focus*". Wow! Did they really say that? How are financial incentives going to sit in that mix? Once again, I don't know – but I do know that our businesses won't survive for very long if we can't engage and motivate this generation who are about to be 60% of the workforce. If this survey finding remains valid as this cohort ages, financial incentives will need to be contingent on quite different factors to those traditionally used: specifically, individual financial performance.

Fourthly, the issues of immediacy and meaningfulness (how quickly do I get the loot, and how significant is the amount relative to total earnings) are worth a look. Where financial incentives seem to change behaviour and ultimately financial performance, they have two features: they are paid frequently, and they comprise a big chunk of total remuneration.

We usually don't do this. Most firms that I encounter that use performance bonuses usually pay them on fees collected, annually ('Do a great job this January and I'll add your bonus up next February'). As to quantum, many firms pay bonuses as a percentage of fees generated beyond budget or expectation. In Australasia most productive lawyers average six chargeable hours a day (we'll pause here while the Americans get up off the floor); most are chargeable for 70% of their day. Using quick and dirty maths, that's an 8-hour day without lunch. If I work another four hours each day – that's 2.4 chargeable – I might, depending on the system, qualify for a $2000 bonus in a year. It's starting to sound like one of those Groucho Marx things. Paraphrasing, with apology: Anyone who's silly enough to strive for the bonus is probably too silly to employ.

And finally but most significantly, do financial incentives, as they are usually implemented, really serve the client's interest? No. I can't think of one single example.

'Too many questions and not enough answers here, Oakes,' I hear you cry. Fair point. The fact is we really don't have a full appreciation of if and how financial incentives work. Oh, they'll work brilliantly if they are enormous: Look what they did for banking. They'll work like a dream if they form 60 to 70% of total remuneration. Go and ask real estate agents. They'll work if they are immediate and tangible. If I walked into your office every Friday and slapped 30% of that week's billings down in cash, it would probably get your attention – for a while. But are incentives really the best way to build client trust, loyalty and ultimately total satisfaction? I doubt it.

I accept of course that different cultures view financial incentives differently, some placing greater trust in them and presumably yielding greater utility, but clients are clients the world over. Ability, availability, accessibility, affability and affordability remain the primary needs of clients everywhere. Which of these are advanced by financial incentives?

So, the tough question to the consultant: Do financial incentives work in law firms? The consultant's inevitable answer? 'It depends…."