The Unrecognised Impact of Merit-Based Incentives

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Changing the way executives in professional service firms are compensated can help organisations address some tough organisational dilemmas.

The global financial crisis in the late 2000s saw a **trend** among law firms and other professional service companies towards corporate compensation structures ensuring those partners who contribute to firm goals are compensated at higher levels. While this move from traditional seniority-based, lockstep structures to more merit-based forms of compensation may appear a fairer way of allocating profits, little attention has been given to its impact on the organisation of work within a company.

Research has shown that as well as **stifling innovation** monetary incentives can lead to unbalanced workloads for top executives and a lack of cooperation or sharing of clients and projects, often to the detriment of the firm.

The challenge of cat herding

Professional service companies rely on employees and executives with strong knowledge of the firm and its workings to maintain a competitive advantage. Managing these valuable employees and executives, particularly those with greater firm-specific human capital and thus substantial bargaining power, can be a challenge. In fact **cat-herding** – a term used to describe the management and direction of strong-willed executives who value their autonomy and the freedom to pursue their own interests – is one of the most pressing dilemmas of human capital intensive companies, with the more valuable performers often looking to "game" the company's compensation system to their advantage. Understanding how to resolve this challenge is crucial to strategic management.

In recent **research** we have examined the way professional service firms allocate their key individuals to incoming projects and the role monetary incentives play in aggravating or mitigating the dilemmas posed. While looking at the issue through the context of U.K. M&A law firms between 2003 and 2005, we found that, as expected, partners had a tendency to be attached to too many projects and not share work fairly.

One of the first things we noted was the way firms actively sought efficiency by attempting to divert new projects away from partners who already had full work-loads, towards those who were "less busy". At the same time they would make great use of their more valuable lawyers, those with greater firm-specific human capital, who were stretched across a greater number of projects.

'Gaming' the system

In firms where compensation was largely merit-based, lawyers were more likely to use their firm specific knowledge to lobby or "game" the system to have themselves placed on an even greater number of projects than was considered efficient. We expect that this would be particularly true for high-profile or "blockbuster" projects from which they would benefit either financially or by reputation. Ironically, it was the lawyers who were considered more valuable to the company, because of their greater firm-based knowledge, who were more likely to game the system, posing a greater threat to the company.

In contrast, we found that when firms had compensation systems based on firm performance with compensation apportioned according to seniority, there were fewer incentives for partners to hoard projects and executives

were more amenable to sharing clients and projects. This allowed for more efficient allocation of specialisation, pointed towards the firm's interest rather than individuals'. Clients also benefit from this as firms are more likely to appoint a greater number of lawyers to each project and to include partners whose specialisations are specific to the mandate.

In short, by weakening individual performance-based pay incentives star lawyers are less likely to monopolise projects or stretch themselves too thin. Powerful individuals, particularly those who derive their status from firm-specific knowledge, are less likely to misuse their influence to further their own interests in the project allocation process to the detriment of the firm.

While this is not to suggest that compensation systems based on merit should be entirely avoided (this system has shown to be an efficient way to deal with underperforming partners), it does highlight the trade-off between rewarding personal performance and balancing workloads while fostering collaboration among professionals. It identifies the challenges firms face when deciding on how to use resources judiciously, and demonstrates the way the design of a company's incentive system can be used to deal with the conflicts of interest that can occur when allocating key individuals to projects.

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