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Patterns of Profit-sharing in Professional Firms[1]

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In recent years the traditional method of distributing profits on the basis of seniority in professional firms has come under attack because of its poor incentive properties. Using data on large law firms, this paper examines the extent to which new forms of profit-sharing based on individual performance have been introduced and whether these are associated with the more systematic control of the core of professional staff and more 'business-like' methods of managing, as has been argued in the American literature. The results suggest profit-sharing innovations are limited in scope and only loosely associated with wider changes in partnership management. Explanations for the persistence of traditional methods of sharing are developed from the data and it is argued that existing accounts present an over-rational model of change in which too much emphasis has been placed on the importance of individual incentives to achieve performance. Profit-sharing policies are driven by concerns to sustain cooperation and professional values about the appropriate way to distribute rewards.

Keywords: ***Profit-sharing, professional firms, incentives, co-operation***

Introduction

There has been increased interest among employers and policy-makers in the use of profit-sharing as a way of fostering greater identification among employees with their employer and a means by which employees can bear some of the risks and rewards of the enterprise (Bhargara, 1995; Ehrenberg, 1990; Gomez-Mejia and Balkin, 1992; Weitzman and Kruse, 1990). This interest has been paralleled by extensive discussion within professional firms in the UK and North America about the most appropriate forms of profit distribution. Traditional methods based on seniority have come under attack from commentators and consultants who have favoured a greater stress on individual performance (Hodgart Temporal, 1992; Maister, 1993). At the same time more 'business-like' methods of managing the firm and its core professionals have been observed, raising the question of whether, and how far, these changes go together.

One problem is that little is known about actual patterns of profit-sharing particularly outside the USA. As Nelson (1988) noted, the debate on rewards is 'remarkably uninformed by data on how firms actually do compensate' (p. 191). This paper aims to bridge the gap by investigating profit-sharing in one profession to see how far seniority has been superseded and to examine whether change is associated with the further rationalization of partnership management. It thereby aims to add to our understanding of how the professional firm is evolving, and the nature of management within it.

The research is focused on law firms in the UK. Law is a well-established profession and one which has been extensively researched in North America but not elsewhere. It has also experienced many of the trends affecting other professions in the last 15 years, including statutory changes in

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regulatory systems opening up competition from other occupations, massive fluctuations in client demand and the internationalization of the markets for legal services.

The rest of the paper is organized as follows: the first section describes the size and structure of the legal profession and partnership organizations. Next we review the theoretical debate on the role of profit-sharing and the nature of management in the professional partnership. The next section presents new data on the patterns of profit-sharing, firm organization and human-resource practices and policies drawn from a survey of large law firms in the UK. The implications for understanding profit-sharing and the management of the professional partnership are then discussed and we conclude by summarizing the main findings of the paper.

Background: partnerships of solicitors

The legal profession in the UK is divided into barristers and solicitors. The former act as advocates in court and offer expert opinion; they may organize collectively but are self-employed. The latter have recently acquired certain rights to represent clients in lower courts but in most respects remain separate from barristers in work, training and organization. The solicitors' professional body, the Law Society, regulates the professional standards of its members through its code of conduct, and controls entry to the profession through qualifying examinations. Barristers are regulated separately by the Bar. Fee scales for commercial work no longer exist although legal aid prices are prescribed. Solicitors in private practice are either sole practitioners or organized in partnerships to provide advice to clients, mostly outside the courts. The number of solicitors in private practice has risen substantially, particularly since the statutory limit on the size of partnership firms was removed in the late 1960s, and in the twenty-year period from 1973–1993, the number of solicitors in private practice rose from 23 821 to 50 538 (Law Society, 1994).

The legal profession is not as concentrated as accountancy, and the large majority of firms are still sole practices or very small partnerships. 82% of firms had between one and four principals in 1993 and only 406 (5%) had more than ten partners, but this latter group employed 40% of the qualified solicitors working in private practice. The largest firms also have a disproportionate market share. Firms with more than 25 partners constituted 1.5% of the total population of legal partnerships but captured 40% of total fee income, which amounted to £6.2 billion in 1993 (Law Society, 1994).

The market for legal services for solicitors is clearly differentiated and law firms can be classified by client type (Bowles, 1994). The largest firms provide legal services wholly or mainly to large corporate clients and are organized departmentally by areas of expertise, such as litigation, merger and acquisition or corporate finance. These firms enjoy higher prestige within the profession and earn greater fee income per lawyer than other firms (Heintz and Laumann, 1994), particularly the elite group of very large firms located in the City of London which have the biggest clients and strongest reputations for expertise (Flood, 1988). The second tier of firms is somewhat smaller and tends to be located in London and the larger provincial cities. These firms undertake corporate and private work but cannot claim the same depth and breadth of expertise and their work is often of a more routine nature. Some of the larger regional firms have started to compete with the elite City firms for the more routine aspects of corporate business by pricing their work aggressively. Mergers within this second tier have also tended to intensify price competition.

The third and largest group of firms consists of small firms mostly serving the private individual market in property conveyancing, probate and divorce work. In order to draw comparisons with the North American literature which has focused on the large law firm, this paper deals with the 406 large law firms (ten or more partners) that fall into the first two categories described above.

Partnership structure and profit-sharing

The internal organization of partnerships consists of equity partners who are the owners of the firm (sometimes called principals) and working lawyers (sometimes called assistant solicitors) who have qualified and are usually working their way towards a partnership; there are also unqualified trainees, formerly called articled clerks,

undergoing the required two-year on-the-job training, and support staff who may be paralegals, administrators and secretarial staff. A number of firms have subdivided partnership into salaried and equity status. Salaried partners have the work responsibilities and title of partner but without the rights to share profits or to be involved in all strategic decisions regarding the firm's future.

Profit-sharing has traditionally been based on the lock-step principle in the UK and North America, at least in larger law firms. Lock-step is essentially a seniority-based system whereby any cohort of newly appointed partners follows a rigid set of steps up to a maximum percentage share and thereafter maintains that share of the total profits until (or 2–3 years before) retirement. In this system, partners increase their share of equity and profits over time, regardless of their contribution to the profit of the firm or marginal productivity. Subtle variations on the lock-step theme observable in practice include the rate of progression from entry to the top of the scale ('plateau') and the number of increments by which progress is made: a lock-step might, for example, be eight increments over ten years or six steps to the top of the scale over 12 years. Given that many law firms promote to partner between six and ten years after qualification, partners in lock-step firms may expect to spend 15–25 years at the top of the scale.

There are persuasive theoretical arguments for and against the use of seniority. The main criticism of seniority resides in its lack of individual incentive properties (Abowd, 1990). For economic theorists concerned with agency problems, the absence of individual incentives in the reward system is important particularly in the context of the professional partnership (Jensen and Murphy, 1989). These theories start by understanding the professional partnership firm as an organization in which human capital is the only tradeable asset. Professionals form partnerships to share risks by pooling expertise, and when the principals have enough surplus human capital value they employ others (agents) to deploy this value on their behalf (Galanter and Palay, 1990; Gilson and Mnookin, 1985). The internal organizational problem facing the firm then becomes how to avoid shirking. This is particularly difficult in the typical context of the professional firm where close supervision is difficult or inappropriate, cooperation is important and output is extremely hard to measure (Eisenhardt, 1989).

The solution with respect to non-partners is to provide the incentive of partnership. However, existing partners may also free-ride by claiming the right to shares of profits which exceed their individual contributions (Leibowitz and Tollison, 1980). This may simply reflect a lack of effort or it may be the consequence of refusing to cooperate with others and thereby failing to maximize fee-earning opportunities. Free-riding may also occur because a partner concentrates on work which is of personal interest but has a poor pay-back to the partnership. The solutions suggested in the economic literature are a combination of mutual monitoring amongst equity partners and the annual renegotiation of a partner's share on the basis of past performance and likely contribution to the firm's future net cash flows (Fama and Jensen, 1983a, 1983b; Kandel and Lazear, 1992).

However, these proposals do not resolve the original difficulty of assessing performance where the product is an intangible, complex and relatively customized service. Firms typically try to control the risk of free-riding by monitoring work input, for instance by recording hours billed to clients, but such methods are likely to be crude proxies of individual contribution to the partnership's profit. Individual performance is not simply a function of effort or efficiency, and assessing the professional's performance is made more difficult by the task autonomy typically enjoyed by professionals. Seniority may have therefore survived because it avoids the calculation difficulties that individual performance systems attract or the transaction costs of monitoring output (Alchian and Demsetz, 1972). Seniority may also contribute positively to firm performance by encouraging cooperation, with the result that partners are willing to share clients and exchange information in ways which create greater value and profits than they could achieve individually over the long run. It may also be linked to performance by rewarding the progressive accumulation of firm-specific knowledge and client reputation, both of which rise with experience, and enhance productivity and professional effectiveness (Leibowitz and Tollison, 1978).

The problem is that these arguments do not explain why, given the long-standing preference for seniority in professional partnerships, firms appear to be breaking with tradition at this time. Rather, the shift to profit-sharing systems with stronger incentive properties is explained as part

of a wider phenomenon whereby the partnership firm is becoming more 'business-like', that is to say, controls through bureaucratic methods common to the incorporated firm are being applied more extensively to partnerships (Greenwood and Lachman, 1996).

Bureaucratic methods have long existed in larger partnerships mainly to schedule work, and there has been extensive debate on whether and/or how these methods are reconciled with professional norms and systems of authority (Abernethy and Stoelwinder, 1995). Smigel's (1964) classic work on large US law firms was one of the first to refer to the resulting hybrid as the professional bureaucracy, because bureaucratic features coexist with, and are moderated by, professional methods of coordination (Hall, 1968; Montagna, 1968; Scott, 1966). Control is typically in the hands of an elite group of senior partners and there is an emphasis on keeping to a minimum formal management responsibilities and hierarchy (Nelson, 1988; Starbuck, 1992, 1993). Practices such as rotation through key administrative roles and the fixed term of office mean that a permanent, powerful central staff concerned with the administration of the firm and separate from the partner elite, is unlikely to take control. Major decisions concerning the strategic direction of the firm usually involve extensive consensus-seeking among the partners, but few are actively involved in day-to-day decisions regarding the firm (Greenwood, Hinings and Brown, 1990; Hinings, Brown and Greenwood, 1991). Committees are extensively used to reflect the principle of partnership and provide an alternative to hierarchical authority. Partners in management positions usually maintain a fee-earning base in order to retain influence in the partnership and the currency of their professional expertise. Management is a 'necessary evil' – an overhead cost to the firm – which is minimized wherever possible, to allow professionals to practice unimpeded by administration, and thereby free to maximize fee income.

Recently, it has been argued that the management of professional partnership firms is being further rationalized. That is to say, the goals of technical efficiency and the profitable deployment of resources have been more systematically and single-mindedly pursued at the expense of wider professional concern mainly by the adoption or elaboration of business techniques such as strategic planning, financial control, client marketing, quality control and process redesign (Cooper *et al.*, 1996; Maister, 1993).

Client relationships have also become more transaction-based, that is, clients have become less committed to a long-term relationship with a single supplier of legal services and competitive tendering for work has become an increasingly common practice. This has placed greater premium on the skills of generating client business among partners (a practice known in the profession as 'rainmaking'). Greater size, increased specialization and new professional areas (for example, environment law) are said to have led to internal reform of the large law firm, so that it has come to resemble the large corporation in internal organization and operate 'more like a business' (Galanter and Palay, 1992, p. 49).

For the firm's internal labour market, there are a number of important consequences of these developments. Traditionally, the firm offered the incentive of promotion to partner from the ranks of the employed solicitors with partnership offering permanent tenure. This was made possible by conditions of steady long-term growth in demand for legal services and a stable set of clients (Galanter and Palay, 1990, 1991; Gilson and Mnookin, 1985; Wholey, 1985). The reformed firm places more emphasis on the development of specialist rather than generalist legal skills early on in a lawyer's career. There is also more overt competition from the external occupational labour market as firms seek to recruit partners with rainmaking skills or teams of lawyers with scarce expertise. Consistent with the development of more open labour-market conditions are forms of profit-sharing that place emphasis on individual performance and tolerate greater inequalities in partner profit shares. At the extreme end, 'eat what you kill' formulae have been introduced, providing to partners only the profits from clients for whom they are personally responsible (Galanter and Palay, 1992). However, the evidence supporting these models of innovation has been gathered in North American firms and its applicability to the UK remains open to question.

Examining patterns of profit-sharing in large law firms, our empirical research addresses four main issues. First, it considers whether, and how far, the lock-step or seniority system has been superseded by systems that place emphasis on individual performance. In other words, is there convergence with what, anecdotally at least, is

said to be happening in the USA? Second, if this change is detectable, is it consistent with the argument that it is the largest firms which have pursued performance-based rewards? Third, are performance-based systems of profit-sharing commensurate with the rationalization of control of the firm and with trends towards weaker internal labour markets, as firms seek to hire lawyers skilled at client development or with scarce forms of expertise? Fourth, do the actual patterns of profit-sharing demonstrate how firms resolve the theoretical benefits and disadvantages of rewarding according to performance or seniority?

Research methods and findings

Following pilot work, a postal questionnaire was sent to the managing partners in the 406 law firms in England and Wales with ten or more partners in June 1993. The data were gathered as part of a study of the management and organization of partnership firms in four professions. After a reminder letter, 144 usable returns were received, a response rate of 35.5%. Whilst not a high return the sample matched reasonably closely the population of large law firms in terms of size distribution and geographic spread, suggesting different market segments were covered. We do not know how accurately the sample reflected the use of different profit-share systems in the population as a whole, but discussions with various managing partners and other researchers confirmed our findings were close to their informed estimates which converged on two-thirds of large firms using lock-step.

Partnerships are not under an obligation to publish their financial results and law firms are generally unwilling to reveal any data formally or informally. Indeed, the most common reason given by firms for declining to complete the survey was because the data were confidential to the partners. We could only gather indicators of financial performance and size. The questionnaire asked for annual fee income to be given within certain bands and whether profits had risen or fallen over the past three years.

From a sample of 40 firms (greater than ten partners) it was also possible to obtain more quantitative and qualitative data through interviews with the senior or managing partner. These firms were selected from four different geographic areas to try and obtain an understanding of regional variations and market sector differences. The areas were the north of England, the Midlands, outer London and the City of London. Eighteen of the firms interviewed also returned a questionnaire enabling us to cross-check the interview and survey data. No substantive inconsistencies were uncovered. These data were used to help make sense of the findings from the questionnaire survey and are referred to in the discussion below.

The dependent and independent variables

The dependent variable was the system of profit-sharing, and initially was divided into three groups. The first group contained those firms that distributed profits exclusively on a lock-step basis and the second those distributing on an equal shares basis. The third group consisted of those distributing wholly or partly on the basis of performance of the individual partner measured by fees earned and/or merit assessment. The distribution of these three groups was equal shares 12%, lock-step 64% and performance 24%. Seniority is therefore the predominant form of profit distribution among larger law firms in the UK. These results were close in aggregate terms to those obtained in the sample of firms we interviewed, where 53% had a pure lock-step system.

We then divided the firms into three separate size categories (10–19 partners, 20–39 partners and 40 partners or more) which broadly correspond to the market segments described above. Descriptive data on the results for each size category are in Appendix 1. Choice of profit-share system appears to be related to firm size and market segment. Analysis of the equal-shares firms showed they were almost exclusively at the smaller end of the size range, that is, they had 10–19 partners (see Figure 1) and the average size of this group was 12 partners. Neither lock-step nor performance profit-share system was exclusive to any size category but 95% of the largest firms, typically in the market for corporate legal services in the City of London and trading on a reputation for great expertise, use a pure lock-step system (the same is apparently true of the elite firms in the United States). However, this type of system is also used by a majority (59%) of the relatively small firms and 58% of the medium-sized firms within our sample size range and they compete in entirely

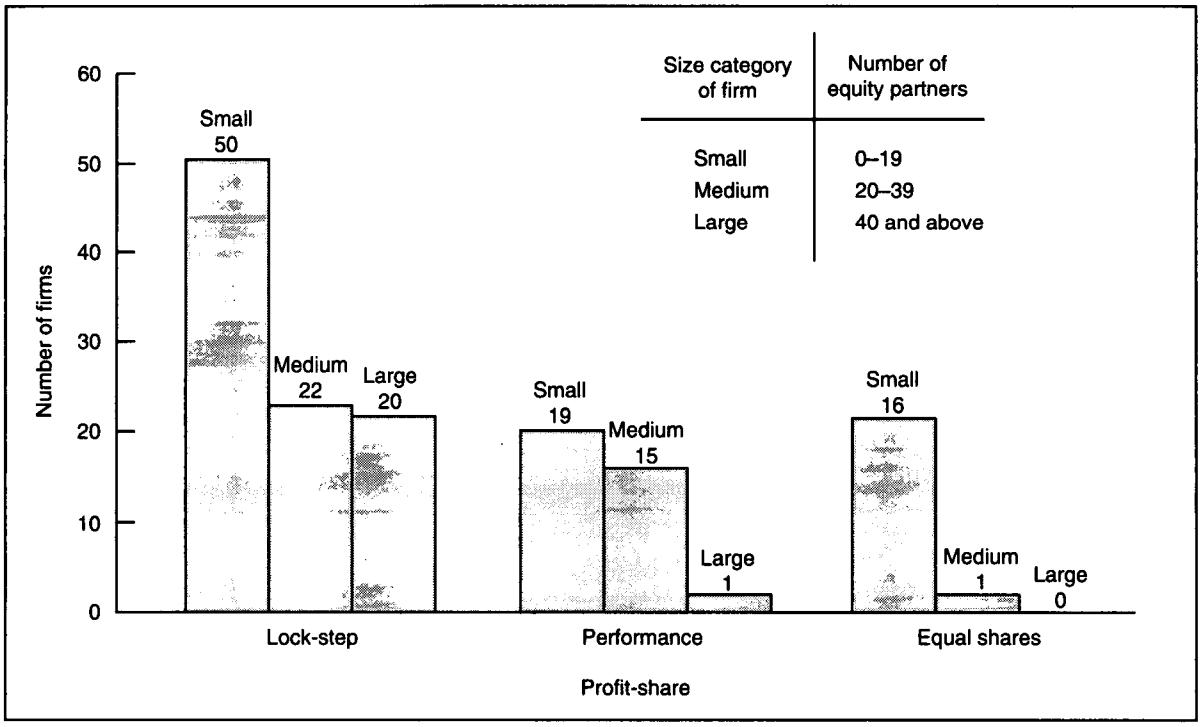


Figure 1

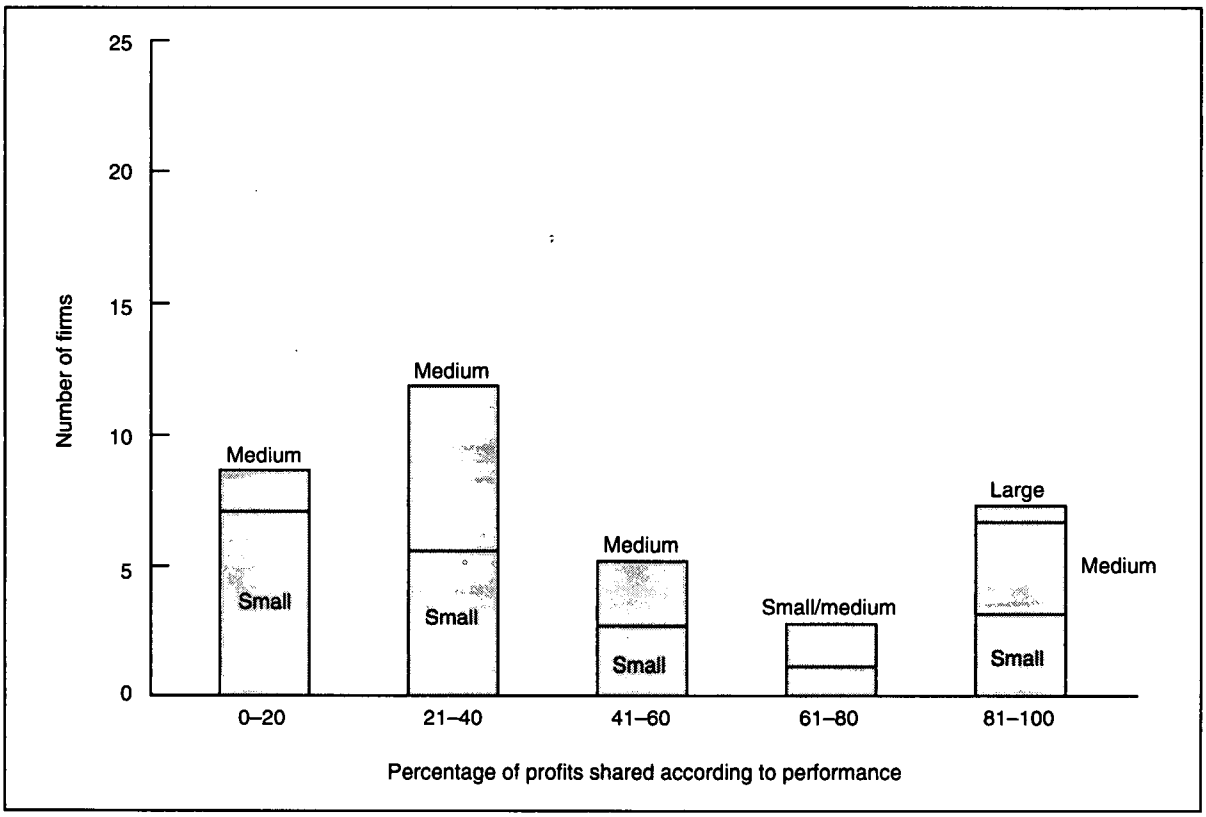


Figure 2

separate market segments for more routine services and much more on cost. Performance-based profit-sharing is rare in the largest group but is used by the medium and smaller-sized groups.

Figure 2 shows the distribution of the performance element within the sample. Most firms share less than half of total profits on a performance basis, mixing this with a non-performance criterion such as seniority, but about 22% use performance to determine the lion's share of partners' earnings. Analysis of those relying wholly on performance to share profits revealed they were mid-sized firms with 20–30 partners.

The independent variables cover firm size and performance, strategic planning, management controls and a set of human-resource policies concerned with the management of the internal labour market. The firm size variables include numbers of equity partners, salaried partners, professional and non-professional staff and fee income (in bands). Performance measures included the leverage ratio of professional staff to partners and recent change in profit performance. The other variables were selected to indicate a formalized and business-like approach to managing the firm. They covered three areas: the existence and responsibility for partnership strategy; incorporation within the strategy of human-resource policies; performance controls at the levels of the partnership, department team and individual. The human-resource variables concerned policies and practices for recruitment from outside the firm; training and development; promotion systems and criteria; the existence, role and coverage of formal evaluation systems for partners and other professionals staff and rewards. Descriptive statistics for the dependent and independent variables are listed in Appendix 1.

Survey results

Analysis of the relationships between the three types of profit-share system – lock-step, performance and equal shares and the independent variables – showed that firm size as measured by number of partners was a statistically significant factor (at the 0.05 level of significance), with equal shares negatively correlated ($r = -0.205$) and lock-step positively correlated ($r = 0.197$). Performance-based sharing was not significantly correlated to size of firm for the sample as a whole but performance-based firms were significantly more likely to have a finance director than others (chi square 4.16, significance = 0.04) and to appraise their partners (chi square = 4.34, significance = 0.037) presumably to allocate rewards. None of the other variables showed a significant relationship. A summary of the full results of the correlations and cross-tabulations is available on request.

The next stage of the analysis was to focus on the differences between performance-based sharers and non-performance based sharers by combining the lock-step and equal-share groups. This enabled us to address the central research question of whether the adoption of performance-based sharing represented one element of a broader change in the nature and organization of the professional firm, towards what Cooper *et al.*, (1996) term the managerial professional business (MPB). They argue, for instance, that this represents a qualitatively different archetype to the traditional professional partnership (p. 634) and that in the MPB: 'Partner compensation is based on a person's perceived contribution to the firm. More elaborate criteria for assessing contribution are developed ...' (p. 633). The objective was, therefore, to examine whether our data could confirm performance-based compensation schemes for partners were associated with a more corporatized form of management of the firm. The results follow.

1. Size and performance variables

The leverage ratio of the firm, that is the proportion of professional employees to equity partners, which is frequently taken as an indicator of potential for profitability, was included as a measure of firm performance but was not significantly correlated with type of profit-share system. Further, no significant correlation was found between profit-share and reported change in financial performance over the past three years nor with financial size (measured by fee income).

2. Strategic planning

Just under half the firms (48%) said they had a formal strategy governing their activities over the short and medium term, and larger firms were more likely to have one than the other groups. However, cross-tabulation showed performance-based profit-sharers, which were

mainly concentrated in the small- and medium-sized groups, are significantly more likely to have a formal strategic plan (chi-square 5.367; significance 0.020) and for that plan to incorporate recruitment (chi-square 6.195; significance 0.045), pay (chi-square 5.06, significance 0.024) and promotion decisions (chi-square 3.727; significance 0.05). At the 10% level, training and development were also significant in this respect. No differences were found between the two profit-share groups with respect to who has overall responsibility for the direction of the firm.

3. *Financial and management controls*

There was no difference between the two groups on the introduction of business planning, quality or productivity controls across the firm. A majority in each group had extended controls on business planning, but only a minority had strengthened controls on productivity and quality. However, firms in the performance group are significantly more likely to have introduced budgetary systems in departments in the last three years (chi-square 3.61, significance 0.05). This does not mean they are now more tightly managed than lock-step firms because the latter group may already have had such systems in place. We also do not know how they use these systems, thus the evidence is indicative rather than conclusive. However, the performance-based group also had, on average, more controls in place over individual partner performance than the lock-step group, and they more frequently measured profit at the level of the individual partner than did lock-step firms (equal-share firms did not measure profit below the level of the firm, unsurprisingly). The existence of a finance director was significantly associated with both the performance and the lock-step groups, suggesting that equal-share firms were the odd ones out here.

4. *Human resource policies*

Lateral recruitment of partners was not significantly associated with either profit-share group; however, while the external recruitment of professionals below partner was related to use of a performance-based system, it was not related to use of lock-step. Future intentions to recruit on the external labour market were not significantly related to the profit-share system.

Appraisal of partners was conducted only by a minority of firms but, as would be expected, performance-based profit-sharers were significantly more likely to do so than the others (chi-square 13.48; significance 0.000). Appraisal of non-partners is much more common (80% of firms appraise their fee earners) and there was no difference between the two groups in this respect. However, performance-based firms are more likely to use the appraisal system to assess the career potential of their professional staff before they make partner. On the other hand, the use of individual performance criteria in profit-sharing does not appear to influence the wider use of performance-based pay in the firm: merit pay remains a relatively rare practice, with only 22% of firms rewarding thus (25% of performance firms; 21% of lock-step firms).

To take the analysis of partner evaluation further, the respondents were asked to rank order criteria used to measure individual performance, whether or not a formal system of appraisal was used. Across both types of profit-sharing system the criteria for individual partner performance were the same: financial concerns with regard to fee earning and business generation predominated, while technical competence was a distant third and management ability last, although lock-step firms appear to place more emphasis on management ability. The difference between the groups appears to lie in the use of a formal system rather than the prioritization of the criteria for partner assessment.

Two items on promotion were included, one concerning the system and the other the criteria for selection. The use of the traditional up-or-out system, a tournament-based method of selecting candidates, was expected to be related to the use of seniority (Galanter and Palay, 1992) and while it was more likely to be found in lock-step firms it was the minority practice in each group, being used with 30% of lock-step and 20% of performance firms, a difference which was not statistically significant. Second, the rank ordering of the criteria for promotion to partner proved to be similar across the two groups, with fee-earning ability and business generation most important. This is consistent with theoretical models of promotion decision in professional firms (Malos and Campion, 1995; Tolbert and Stern, 1991). Finally, the performance group were more likely to have appointed a personnel director.

Therefore, with the human-resource policy variables there were only two notable differences between the performance and the lock-step groups – use of formal partner appraisal and appointment of a personnel director. The ranking of substantive criteria for evaluation and promotion were similar and both groups appear to be adjusting their internal labour markets in similar ways.

Discussion

The survey results show that, contrary to the US literature, lock-step has not been substantially replaced by performance-based systems. A partner's share of profits is unlikely to be largely related to individual performance because the majority of firms operate on the basis of seniority or, in the smaller firms, equal shares. Even where a performance element is included, it does not make up the majority of the partner's profit-share and is more of a supplement to the largest tranche. Large firms were more likely to use lock-step than others and are traditionalists rather than innovators in this area. Convergence with what is said to be happening to professional firms in the US was not therefore observed. The results also showed that while the rationalization of the firm is occurring generally, it was associated somewhat more strongly with performance-based sharers, particularly in the use of a business strategy that incorporates components of human resource policies. By contrast, the internal labour market policies of firms did not differ widely with their profit-sharing method and the most notable difference was in the use of formal evaluation by performance-based sharers, a logical finding given the form of profit distribution.

However, use of a performance element of profit-sharing appears to be linked to tighter financial control over individual partners as well as the firm. This is intriguing because the agency theories referred to above would predict the opposite. That is to say, seniority-based firms would monitor most extensively because the risk of shirking was not mitigated by the presence of incentives in the reward system. It may be there is a time-lag in the adoption of financial controls between different types of profit-sharers, with non-performance based firms following performance-based ones. It should also be noted that the findings presented above indicate this is a matter of degree rather than absolute difference.

The central question that remains unexplained, therefore, is why non-performance related forms of sharing remain so prevalent, given the critique that they do not mitigate the risk of free-riding by a partner on the efforts of his/her peers, or fully reward the contribution of those who generate the most business, making them attractive to other firms. In the following discussion we draw on the interview data to examine the perceived benefits and disadvantages of different systems in order to address this issue.

First, we found that the assumption that seniority systems are not performance-related was not correct. In our questionnaire sample, two-thirds of firms with lock-step systems indicated progression through the scale was contingent on satisfactory performance. Similarly in our interviews, 60% of firms used a pure lock-step system and it was universally confirmed that progression is never wholly automatic. No firm was without the sanction of being able to freeze a partner's share or reduce it and when asked how often such a sanction was actually used, every firm claimed it had been considered or actually implemented in the last ten years. Because lock-step is conditional on what the senior partners define as satisfactory service, it is much closer to a performance-based system. The standard reasons for removal from the lock-step were failure to generate sufficient fee income or meet standards of professional work over a period of two or three years, both of which indicate the performance assumption underpinning the system. Furthermore, just over half of the firms using lock-step indicated they had extended the performance requirements of the system in the last five years, by being able to freeze or reduce further a partner's share when they were underperforming. One respondent likened the new system in his firm to 'snakes and ladders'.

Second, seniority and equal-shares systems persist because they are perceived to have real benefits over the alternative. They are believed to reinforce the fabric of the firm, emphasizing the returns to the individual and the firm from cooperation.

> 'Trust, co-operation, everyone gains by working for the common good of the firm and not just for themselves ... Go down the road of individual shares and you lose the benefits of working

> together . . . it ends up with a situation where this wouldn't really be a firm, just sharing the office overheads.' (Managing partner, City of London firm)

Usually these benefits were contrasted with the costs of performance-based rewards.

> 'When you get a group of managing partners meeting together, the underperformer problem always comes up. But the more I've talked to [partners from firms with performance based systems] and my colleagues here, the more measuring and sharing out the profits by a partner's performance over the past twelve months looks a mistake. Its not the way to deal with it [underperformance].' (Managing partner, City of London firm)

Indeed, lock-step may persist because firms do not choose to deal with free-riding by monetary incentives. Rather, there was a clear trend towards dealing with poor performing partners through dismissal, whereas ten years previously partnership tenure had been unconditional. Dismissal was said to negate the need for performance incentives and avoid its unwelcome consequences.

While lock-step was believed to sustain firm cooperation, performance systems were thought to discourage it. Individuals ended up not sharing resources, time and client referrals and the potential for disputes about who gained what from fee income placed strains on the firm. The risk of break-up or of becoming known as a divided organization among clients influenced policy decisions about rewards. Emphasis was placed on solidarity-building devices as well as individual performance, or being 'risk-averse' as one managing partner put it. Indeed, the main reason performance-sharing firms only allocated a small proportion of total reward on that basis was the perceived risk of disagreement among the partnership. One said

> 'We all privately rank ourselves against our colleagues and know who is and who's not really pulling their weight, but that's not the same as doing it publicly. Some of my partners don't like it and they would not wear it if we tried to change things.' (Senior partner, North of England firm)

A partner in a smaller firm, with 18 partners, said performance assessment and rewards were rejected because:

> 'We didn't like the idea of more committee work and partners – friends and colleagues – sitting in judgement on each other. That would tear this firm apart.' (Managing partner, small specialist firm)

Respondents from eight firms not using performance-based sharing, and six firms that did, also expressed the view that performance-based systems could compromise professional reputation. Thus, individual incentives might lead professionals down the path of exploiting clients to obtain more fees by 'keeping the argument going' when involved in litigation, or not seeking the most simple and cost effective solution. One said:

> 'Even in some firms I admire, I notice more and more of that sort of game playing. I know a lot of my colleagues agree with my view that this is driven by targets and performance measures. It's not really in anyone's long term interest.' (Partner, Midlands firm)

Thus, the reputation of the profession as a whole was thought to be threatened by playing for short-term gains. Performance systems '. . . could easily make the client relationship more transactional and less that of a trusted advisor' as another put it. Seniority placed less pressure on the pursuit of short-term gain, because it emphasised loyalty to the firm and the creation of long-term client relationships.

Third, value-based forms of argument justified lock-step. Interviewees in 17 (71%) lock-step firms and six equal-sharers explained the choice of profit-share in terms of normative judgements about how partnerships should work and professionals be rewarded rather than in terms of an organizational strategy. This was most strongly expressed by respondents in the largest firms. For instance, this comment came from an interviewee in a City of London firm:

> 'Performance pay works best in industry or the banks. Professionals work for different reasons – pride in the job itself and doing it well, the intellectual challenge. Our traditions are different. To fellow professionals it would be iniquitous to suggest in one year A is 10% better than B and should get that much more.'

and, similarly, from another City firm:

> 'Why do we have it [lock-step]? Because its always been there, as far as I know. It's the traditional way we divide up the surplus. It's not something we question.'

Similarly, in the smaller firms the most common reason given for equal shares being appropriate was because individuals worked closely together as fellow professionals; distinctions based on performance made close cooperation difficult. Thus, efficiency is not the only basis for determining rewards. Professional concerns with norms of collegiality and equality of competence were important determinants of organizational policies.

> 'It reinforces the idea, it's crucial, we are colleagues practising together . . . we bear the whole risk together . . . this is not the same as managers who are paid to make profits for the shareholders . . . we hold collective responsibility for the long-term good of our firm.' (Managing partner, Midlands firm)

Fourth, non-performance based methods of sharing may persist because of the obstacles to change in partnership structures (Hinings *et al.*, 1991). A subsidiary reason advanced by respondents in six lock-step firms was that, even if it was justified, change to the profit-share is intrinsically difficult because it would require the agreement of the whole partnership and would challenge entrenched interests. Under lock-step, the most senior partners, who usually sat on the important executive committees, are the highest earners. A different system might mean some of their rewards were redistributed to more junior partners. Getting the necessary support to take a reform proposal through the whole partnership was therefore politically difficult, even if the senior or managing partner thought it sensible. Those that had changed their rewards confirmed this, emphasizing how much the partners had to be persuaded of the merits. As one of them said:

> 'Usually, business problems – you know – clients leaving, falling profits are necessary before you can move the partnership on a thing like this. It took a long hard look down the barrel of a gun here.' (Partner, north of England firm)

Why, then, did firms adopt performance-based sharing? In our interviews we noted two types of explanation, one of which related to the broader rationalization process, but not directly to the creation of incentives to limit free-riding.

The first type of explanation was that performance-based profit-sharing was appropriate to the modern firm and part of a concerted policy to achieve greater internal efficiency. This argument was found among almost exclusively mid-sized firms which were trying to enter new areas of business by hiring staff from the large London firms, or opening London offices, having lost much of their traditional business in the recession of the early 1990s. Thus, internal changes to profit-sharing reflect greater concern to generate new business and more transactional client relations, as the US literature has argued, but mainly among one segment of the profession.

The second explanation is linked but rests on the influence of external events or outsiders. We calculated that we came across eight firms that had adopted performance-related sharing after having hired consultants or had sent the managing/senior partner on a management course (and one firm where the managing partner had been on a management course and, after a detailed review, favoured staying with lock-step). Managing partners, apparently besieged by sales literature and calls from consultants, were generally aware of the extensive discussions in the trade journals which tended to highlight (and by implication praise) radical reformers. Consultants (and 'head-hunters') and the trade press consistently advised lock-step was out of step with 'best practice' in industry and not the way to 'incentivise your brightest stars' (to quote from one report we were shown). In effect, some form of mimicry of policies outside the profession may be occurring because of the promotion of change by external agents, particularly among the medium-sized firms in our sample. But at the same time, every interview respondent expressed the view that no profit share system could influence individual performance on its own. As one put it:

> 'You might generate activity but that's not the same as being a good partner . . . that happens because [a partner] really wants to contribute . . . You can't just dangle it [profit sharing] like a carrot in front of someone's nose . . . the job is too demanding and complex.' (Managing partner, Edinburgh firm)

Conclusions

Despite much promotional hype in recent years by consultants and in specialist journals, the evidence for innovation in profit-sharing is rather modest. Where firms have moved to rewarding on the basis of individual performance, it has mainly

been combined with seniority rather than displacing it and the performance element forms only a minor portion of the total reward.

This finding is inconsistent with those theories of the partnership which predict the structure of profit-share systems is based on a central organizational concern to minimize free-riding by partners through individual incentives, particularly where work is unprogrammed and evaluation of performance is difficult (Eisenhardt, 1989). Accounts of innovation in profit-sharing and, more broadly, partnership management driven by inexorable firm growth and environmental change also distort the degree of stability in profit-share systems.

A combination of factors appears to explain why profit-sharing is still largely based on seniority. One is that it is applied in a sufficiently flexible way to punish poor performance even if it does not provide inducements for the exceptional individual. The risk of dissatisfaction from high performers believing they were relatively underrewarded, that is subsidizing their colleagues' shares, was thought to be best resolved by the sense of commitment to the firm built through socialization into its standards and values, rather than through the reward system, as cases on other professional service firms have found (e.g. Ferner *et al.*, 1995). Lock-step also persists because profit-sharing policies are not determined solely by concerns for organizational efficiency, but also by the values and standards thought to be appropriate to a professional organization (Hinings *et al.*, 1991). These were strongly expressed by members of the largest firms, who regard themselves as being at the centre of the profession, doing the most complex and innovative work, with high status and rewards (Abbott, 1988). To the members themselves, part of the success of these firms is explained by the use of distinctive policies which reinforce their elite cultures. In the smaller firms, where equal sharing was more common, organizational factors seemed to be more important in explaining the form of profit-share: the importance of close collaboration and limited specialization meant individual performance distinctions would be dysfunctional.

Professional firms may also resist the use of individual performance-based sharing because of the importance of encouraging collective trust (Gilson and Mnookin, 1985) and a sense of shared purpose (Ghoshal and Moran, 1996). These are particularly important in the professional firm because of the form of ownership and reliance on human capital. Partnership means unlimited, shared liability among owners and this requires confidence in the ability and reputation of co-owners (Malos and Campion, 1995). In addition, because professional firms have mobile assets in the form of individual employees and owners, conflict can relatively easily lead to colleagues quitting to become competitors, taking their client following with them. If one of the basic reasons why professional firms form in the first place is to share clients and expertise, the perceived risk of individual-based systems is that they diminish the incentive to cooperate or they encourage client exploitation for short-term gain, and thereby increase the likelihood of the firm breaking up. Limiting competition for rewards and placing weight on rights to a fixed share of the overall surplus appears to be a way of shoring up what are potentially fragile organizations.

Generalized accounts that assert innovation in profit-sharing occurring in conjunction with the rationalization of management of the professional fail to understand the complex way in which firms of professionals respond to change: they assume too much business 'rationality' in decision-making. The rationalist account of change which predominates in the American literature is oversimplified because it cannot easily explain the extent of stability in professional firms. This paper has shown that by taking into account the perceived benefits of traditional systems as they operate in practice, the obstacles to creating new systems based on performance, as well as the power of prevailing professional norms, an explanation which accounts for this stability can be provided.

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Appendix 1. Descriptive statistics for dependent and independent variables

		All (n = 144)	Large (n = 21)	Medium (n = 38)	Small (n = 85)
Management and organization					
Lock-step profit-share system		63.9%	95.2%	57.9%	58.8%
Performance profit-share system		24.3%	4.8%	39.5%	22.4%
Equal-shares profit-share system		11.8%	0	2.6%	18.8%
Size of firm (equity partners)		Mean 25.08 S.D. 29.91	Mean 77.48 S.D. 50.42	Mean 27.5 S.D. 5.75	Mean 11.05 S.D. 3.88
Size of firm (salaried partners)		Mean 5.77 S.D. 6.53	Mean 9.63 S.D. 11.35	Mean 7.95 S.D. 7.42	Mean 4.07 S.D. 3.84
Size of firm (professional staff)		Mean 79.08 S.D. 117.96	Mean 283.16 S.D. 208.59	Mean 93.28 S.D. 49.03	Mean 26.83 S.D. 17.37
Recent performance (profit change over last 3 years – greater)		54.0%	24.0%	42.1%	48.2%
Main responsibility for strategic direction: (choice of 4 stakeholders)					
senior partner/chairman		10.4%	9.5%	18.4%	7.1%
managing partner/ managing director		20.1%	14.3%	21.1%	21.2%
management committee		36.8%	61.9%	44.7%	27.1%
partnership as a whole		27.1%	14.3%	5.3%	40.0%
no reply		5.6%		10.5%	4.7%
Formal plan for medium term	Yes	47.9%	61.9%	47.4%	44.7%
Plan incorporates:					
Rewards	Yes	9.7%	4.8%	10.5%	10.6%
Promotion	Yes	19.4%	4.8%	23.7%	21.2%
Recruitment	Yes	29.2%	28.6%	31.6%	28.2%
Training/development	Yes	31.3%	23.8%	28.9%	34.1%
Human resource policies					
Formal performance appraisal system:					
equity partners	Yes	36.8%	42.9%	52.6%	29.4%
fee earners	Yes	81.9%	76.2%	81.6%	85.9%
Uses of appraisal system:					
assess career potential	Yes	58.3%	52.4%	63.2%	57.6%
promotion to partner decisions	Yes	51.4%	52.4%	50.0%	51.8%
Merit pay for fee earners	Yes	21.5%	14.3%	15.8%	25.9%
Promotion criteria for partnership:					
Getting new business	r/o	1	1	1	1
Fee earning ability	r/o	2	2	2	2
Technical skill	r/o	3	3	3	3
Management ability	r/o	4	4	4	4
Up-or-out promotion policy	Yes	27.1%	66.7%	21.1%	20.0%
Performance assessment criteria for partners:					
Getting new business		1	2	1	1
Fee earning		2	1	2	2
Technical skill		3	3	3	3
Management		4	4	4	4

continued

Appendix 1. *continued*

Cross-tabulation of performance profit share system by independent variables

Variable	All firms ChiSq	n = 144 Sig.	Large firms ChiSq	n = 21 Sig.	Medium firms ChiSq	n = 38 Sig.	Small firms ChiSq	n = 85 Sig.
Management and organization								
Recent performance (profit-share over last 3 years)	0.107	0.743	0.916	0.338	0.247	0.618	0.94	0.332
Existence of a formal plan for medium term	5.367	0.020	0.646	0.421	0.076	0.781	0.007	0.931
Plan incorporates:								
Rewards	5.06	0.024	0.052	0.818	0.449	0.502	0.391	0.531
Promotion	3.727	0.050	0.052	0.818	0.372	0.541	0.069	0.792
Recruitment	6.195	0.045	2.1	0.349	0.532	0.766	0.103	0.949
Training/development	4.95	0.083	1.706	0.426	0.241	0.886	4.315	0.115
Firm has a finance director	5.37	0.020	0.053	0.808	0.026	0.870	0.115	0.733
Firm has a personnel director	2.71	0.090	0.281	0.595	2.879	0.089	0.362	0.547
Introduction of new policies in last 3 years:								
Business planning	0.003	0.955	0.535	0.464	0.914	0.339	3.634	0.057
Quality standards	0.006	0.934	1.09	0.296	1.6	0.205	0.775	0.378
Productivity	0.478	0.480	1.224	0.268	0.001	0.973	0.629	0.427
Budgetary/financial control	3.61	0.050	0.677	0.410	0.079	0.778	1.148	0.283
Human resource policies								
Intention to recruit laterally	2.23	0.134	0.714	0.398	0.11	0.739	1.63	0.201
Performance appraisal system for equity partners	13.48	0.000	0.767	0.380	0.359	0.549	0.214	0.643
Performance appraisal system for fee earners	1.92	0.165	0.302	0.582	0.644	0.422	2.461	0.116
Use of appraisal system to assess career potential	6.73	0.009	0.293	0.587	0.052	0.818	1.456	0.227
Merit pay for fee earners	0.97	0.613	2.692	0.260	3.11	0.374	2.524	0.470
Up-or-out promotion policy	1.66	0.970	2.1	0.147	1.216	0.270	0.019	0.889

		All (n = 144)	Large (n = 21)	Medium (n = 38)	Small (n = 85)
Management and organization					
Firm has a finance director	Yes	68.1%	85.7%	76.3%	60.0%
Firm has a personal director	Yes	38.2%	71.4%	47.4%	25.9%
Introduction of new policies in last 3 years:					
Business planning	Yes	53.5%	47.6%	10.5%	60.0%
Quality standards	Yes	39.6%	28.6%	23.7%	45.9%
Productivity	Yes	34.7%	38.1%	31.6%	32.9%
Budgetary/financial control	Yes	58.3%	38.1%	28.9%	68.2%

continued

Appendix 1. *continued*

		All (n = 144)	Large (n = 21)	Medium (n = 38)	Small (n = 85)
Measures of partners' financial performance:					
Cumulative drawings	Yes	12.5%	4.8%	5.3%	17.6%
New files opened	Yes	22.9%	23.8%	18.4%	24.7%
Time recorded	Yes	45.1%	38.1%	50.0%	44.7%
Hours charged	Yes	52.8%	47.6%	63.2%	49.4%
Time against targets	Yes	37.5%	33.3%	44.7%	35.3%
Fees against targets	Yes	65.3%	57.1%	63.2%	68.2%
Bills outstanding	Yes	66.0%	57.1%	76.3%	63.5%
Work-in-progress	Yes	55.6%	52.4%	65.8%	51.8%
Human resource policies					
Lateral recruitment:					
Equity partners	Mean	0.375	0.476	0.342	0.365
	S.D.	0.486	0.512	0.481	0.484
Salaried partners	Mean	1.39	2.0	1.55	1.165
	S.D.	2.24	3.49	2.001	1.926
Professional fee earners	Mean	0.66	0.333	0.595	0.762
	S.D.	0.477	0.483	0.498	0.428
Intention to recruit laterally:					
Equity partners	Yes	30.6%	38.1%	34.2%	25.9%
Professional Staff	Yes	82.6%	66.7%	71.1%	89.4%

S.D. = Standard deviation.

Appendix 2

	Lock	Equal	Perf	Eq	Sal	Prof	Lev	Receq	Rprof
Lock-step profit-share system	1.0000								
Equal shares profit share									
All firms (n = 144)	**–0.6769**	1.0000							
Large firms (n = 21)	0.500	1.0000							
Medium firms (n = 38)	**–0.5756**	1.0000							
Small firms (n = 85)	**–0.7229**	1.0000							
Performance-based profit-share									
All firms (n = 144)	**–0.4620**	–0.991	1.0000						
Large firms (n = 21)	**–0.7884**	0.0194	1.0000						
Medium firms (n = 38)	**–0.5953**	0.0495	1.0000						
Small firms (n = 85)	**–0.4162**	–0.1400	1.0000						
Equity partners									
All firms (n = 144)	0.1969	–0.2052	0.414	1.0000					
Large firms (n = 21)	–0.0660	–0.0794	–0.1019	1.0000					
Medium firms (n = 38)	0.2162	–0.0883	–0.0489	1.0000					
Small firms (n = 85)	–0.0146	–0.1721	0.2743	1.0000					
Salaried partners									
All firms (n = 144)	0.0297	–0.1221	0.2126	0.871	1.0000				
Large firms (n = 21)	0.2261	–0.2261	0.1407	–0.3696	1.0000				
Medium firms (n = 38)	–0.1183	0.0131	0.2742	0.1553	1.0000				
Small firms (n = 85)	–0.0095	–0.1069	0.1175	0.0351	1.0000				
Professional staff									
All firms (n = 144)	0.1833	–0.2051	0.0777	**0.9195**	**0.2608**	1.0000			
Large firms (n = 21)	0.0164	–0.2219	–0.0214	**0.8562**	–0.1095	1.0000			
Medium firms (n = 38)	0.0965	–0.1959	0.1566	**0.5372**	**0.4377**	1.0000			
Small firms (n = 85)	–0.0641	–0.0997	0.1654	**0.5061**	**0.6331**	1.0000			
Leverage									
All firms (n = 144)	0.0541	–0.0853	0.833	**0.2374**	**0.5750**	**0.4353**	1.0000		
Large firms (n = 21)	0.1903	0.1217	0.0968	–0.2334	0.4135	0.0142	1.0000		
Medium firms (n = 38)	0.1040	–0.2398	0.1142	0.3785	**0.4962**	**0.9267**	1.0000		
Small firms (n = 85)	–0.1198	0.0750	0.0112	–0.1641	**0.7023**	**0.6133**	1.0000		
External recruitment equity partner									
All firms (n = 144)	0.0448	–0.1186	0.1350	–0.0169	0.1205	0.0368	0.0249	1.0000	
Large firms (n = 21)	–0.2345	0.2345	0.4106	–0.3735	0.4856	–0.2069	0.4320	1.0000	
Medium firms (n = 38)	0.1656	–0.3540	0.0408	–0.0147	–0.0265	–0.0211	0.1609	1.0000	
Small firms (n = 85)	–0.0117	0.0539	0.1269	0.2441	0.0186	0.0907	–0.1455	1.0000	
External recruitment professional staff									
All firms (n = 144)	–0.0598	0.0841	–0.0874	**–0.2496**	–0.1201	**–0.2351**	–0.0878	0.1926	1.0000
Large firms (n = 21)	–0.3162	0.3162	0.1635	–0.0848	0.0301	–0.0538	0.2870	0.3371	1.0000
Medium firms (n = 38)	0.0571	–0.0210	–0.2831	–0.0013	–0.1430	–0.1107	–0.2174	0.2193	1.0000
Small firms (n = 85)	0.0378	0.0056	0.0219	0.1526	0.0028	0.0666	0.0218	0.1958	1.0000

Note: Numbers underlined are significant at the 0.05 level.
Emboldened numbers are significant at the 0.01 level.

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