University of Oxford
Novak Druce Centre for Professional Service Firms
Saïd Business School

RE-BALANCING THE PROFESSIONAL SERVICE FIRM: **THE IMPACT OF CHANGING CAREER STRUCTURES ON PROFESSIONAL SERVICE FIRM INNOVATION**

NOVAK DRUCE CENTRE INSIGHTS No. 2

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'WITH THE INTRODUCTION OF NEW CAREER STRUCTURES, INNOVATION MAY SPRING FROM NEW SOURCES IN THE ORGANIZATION AND ENTREPRENEURIAL THINKING MAY TRICKLE DOWN THE ORGANIZATIONAL HIERARCHY.'

Based on the book chapter, 'Changing Career Models and Capacity for Innovation in Professional Services' by Michael Smets, Tim Morris and Namrata Malhotra, published in Markus Reihlen and Andreas Werr (eds.), *Handbook of Research on Entrepreneurship in Professional Services*, Cheltenham: Edward Elgar Publishing, forthcoming in 2011.

THE **INNOVATION IMPERATIVE**

The success of professional service firms (PSFs) largely turns on three key elements: the recruitment and retention of (professional) talent, the translation of talent into client solutions and the continuous updating of service offerings.

Innovation is the sine qua non of PSF success, as clients constantly seek novel solutions to their problems and PSFs need to overcome the problem of knowledge commoditization. As solutions to client problems become widely known, professional service firms risk price reductions and the reputational damage associated with delivering 'cookie-cutter' solutions. For PSFs constant innovation is not an option – it is a necessity.

This imperative distinguishes PSFs from other organizations in terms of their innovation capacity and process. Rather than driving innovation through a dedicated team or R&D (Research and Development) department, the onus of responding to new market demands falls squarely on the shoulders of front-line professionals. Innovation is embedded in the everyday work of professionals at the heart of the firm, rather than in a separate organizational unit. Consequently, the career model by which professionals are recruited and retained is key to the firm's capacity to innovate.

THE CAREER MODEL BY WHICH PROFESSIONALS ARE RECRUITED AND RETAINED IS KEY TO THE FIRM'S CAPACITY TO INNOVATE

THE UP-OR-OUT **PROMOTION TOURNAMENT**

Typically, elite professional service firms have motivated and selected staff by what is termed the 'up-or-out' model of promotion. The up-or-out model is a form of promotion tournament.

Candidates for promotion compete against each other for a limited number of positions at the next level, and success depends on an individual's relative ranking rather than their absolute merits. Those who fail to make the grade are generally barred from subsequent promotion rounds and expected to leave the firm.

The critical tournament takes place when associates seek promotion to partner, moving from the status of salaried employee to that of co-owner with a share in the profits of the firm. The promotion-to-partner decision obviously has important consequences for the candidates but also significant implications for the firm's reputation, its ability to generate profits and the number of owners sharing those profits.

Monitoring staff consistently is costly and difficult, as the relationship between employee input and output is complex and partners or senior professionals are themselves engaged in production as well as management. The up-or-out promotion model provides a relatively cheap, easily manageable alternative, ensuring that only the 'best-of-the-best' remain in the firm while underperformers leave. It maintains a reputation that attracts clients and justifies higher fees, while helping manage the number and quality of those promoted to profit-sharing status.

With such benefits accruing to the firm, why would employees enter such a tournament for promotion? Clearly, deferred compensation – the chance of eventual promotion to partner – is a key incentive. Another *quid pro quo* for the low odds of success is that employees are tacitly assured the promotion decision will take place within a finite period and they will not be left hanging on indefinitely. Moreover, in preparing for the tournament associates gain knowledge and contacts that are valuable in the external labor market should they fail to make partner in their current firm.

Originating among the elite New York law firms in the early years of the twentieth century, the up-or-out tournament model has since become widely adopted by American and British law firms as well as in other professional services such as management consulting and accounting.

However, there is considerable evidence that the up-or-out model has come under pressure by institutional and market changes. Professional service firms have come under increasing pressure to be more corporate or business-like in their structures and systems, including their promotion processes. The up-or-out model has been particularly challenged by changes in the labor market and the 'war for talent' among professional service firms.

THE UP-OR-OUT MODEL HAS COME UNDER PRESSURE BY INSTITUTIONAL AND MARKET CHANGES

TOURNAMENTS UNDER PRESSURE: **CHANGING CAREER MODELS IN THE UK'S ELITE LAW FIRMS**

Novak Druce Centre researchers examined a sample of the top 30 London corporate law firms to assess the external pressures on the tournament promotion system and the responses to these pressures in promotion policies and practices. They found that although most of these firms do not have – and some never had – a formal up-or-out policy, the up-or-out rule nonetheless operates in practice. They also found, however, that recent changes in the market for professional talent have triggered transformations in the promotion system and its underpinning career model that directly contradict principles of the promotion tournament. Most of the firms studied have introduced new positions of permanent employment for associates who fail to make partner. While some of the associated roles are new, others existed in the past but have been formalized and increased in number. These positions include *Of Counsel* (or *Legal Director*), *Permanent Associate* and *Professional Support Lawyer* (*PSL*).

The position of *Legal Director* or Of *Counsel* – a title borrowed from US law firms – is generally open to senior associates with at least eight years' experience who have not made partner or applied to do so. They are at, or beyond, the level of experience required for promotion but lack a strong enough business case to be chosen as partners. The work of both Of Counsel and Legal Directors is nevertheless similar to that of partners and includes some elements of management but little or none of the 'rainmaking' or business development responsibilities that characterize partners' work. The privileges of these positions, however, include access to management information, bonus payments linked to firm performance, and a special status within the firm and the marketplace.

Permanent Associates tend to be found in areas where there is a strong need for experienced lawyers but a weak business case for promotion. Although Permanent Associate positions existed in the past, their formalization and growth in numbers is new. Like Of Counsel or Legal Directors, Permanent Associates often have eight or more years' experience but have failed to obtain partnership or will not be put up for promotion. Unlike them, Permanent Associates are retained for their expertise alone and do not assume any managerial responsibilities. The establishment of these positions helps address issues of talent retention. Moreover, it helps to overcome a distinctive problem in professional service firms – that the only way for professionals with valuable technical expertise to remain with the firm is via promotion to management positions, for which they might be ill-equipped by inclination or ability.

Professional Support Lawyers (*PSLs*) are qualified lawyers who provide support for fee-earning colleagues. Typically paid a salary linked to associates' rates but with only limited bonus opportunities, they are commonly assumed to be following an alternative path to that of the career lawyer and therefore off the partnership track. Many are technical specialists with strong drafting skills used to resolve legal difficulties during transactions. In contrast to other permanent positions, that of PSL is not necessarily geared towards unsuccessful candidates in the partnership tournament who would have been forced out of the firm under a strict up-or-out

MOST OF THE FIRMS STUDIED HAVE INTRODUCED NEW POSITIONS OF PERMANENT EMPLOYMENT FOR ASSOCIATES WHO FAIL TO MAKE PARTNER

regime, but towards senior associates seeking more flexible work demands.

Their role is not entirely new, but was, until recently, relatively rare and informal. It has risen to greater prominence to meet increased demands for a better work-life balance among 'Generation Y' associates. In our firms, the overwhelming majority of PSLs were women, many of whom had taken the position to fit in with raising their families. As PSLs are not directly fee-earning on specific transactions, they can manage working hours more flexibly.

A **'NEW DEAL'**

While formal policies regarding these positions vary and are often deliberately vague, a distinct change is detectable in the general framing and rationale of associates' careers. HR managers in most of our sample firms have devised career development structures that not only advance associates through the ranks of their current firm but at the same time enhance their value in the external market.

Associates are offered a broad-ranging learning and development experience without any expectation that unsuccessful candidates for promotion to partner should leave the firm. One firm explicitly formulated a framework called 'the deal', whereby the firm committed itself to providing associates with interesting and stimulating work on leading-edge transactions, focusing on complex cases and reducing routine tasks for their juniors.

These career developments are significant in that they explicitly acknowledge the need to build general skills. They rest, however, on two important assumptions: that there will be a steady flow of leading-edge transactions on which to deploy junior professionals, and secondly, that these associates will be able to undertake work that is more than routine and will engage in more innovative tasks.

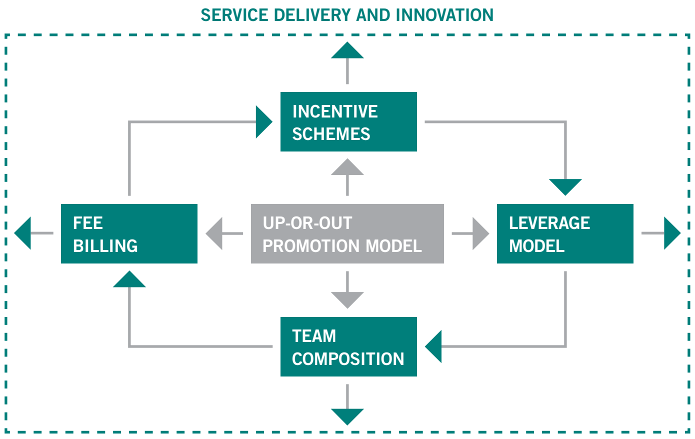
These changes to the promotion system – and the imperatives driving them – have profound implications for these firms' leverage and incentive systems and, in turn, their capacity for innovation.

THE **PRODUCTION & INNOVATION MODEL IN PSFs**

Professional service firms have a relatively straightforward 'production model'. Compared to manufacturing organizations there are few complexities such as extended supply chains, highly departmentalized systems of production needing coordination or complex marketing channels. Instead, production centers on the deployment of expert knowledge to resolve client problems. This means that PSFs' organizing model is also distinctive. It consists of four main elements, as shown in Figure 1.

A combination of *incentives* – primarily the deferred compensation via promotion – secures the continued input and commitment of professional staff. Traditionally, this has meant

FIGURE 1: THE PRODUCTION & INNOVATION MODEL IN PSFs



for partners the delivery of innovative services by applying their knowledge and experience to novel client problems. For associates, it has meant long hours of delivering more routine services using information from knowledge management systems, and engaging in more innovative services only insofar as assisting seniors and learning from them.

Such assistance and learning occurs through *leverage*. Associates 'borrow' knowledge and know-how from their seniors to serve clients on their behalf and gain important experience in the process. Theoretical knowledge that is easily codified, such as legal statutes, is typically leveraged through knowledge management systems. More personal and tacit knowledge that features in the application of such theoretical knowledge is much harder to articulate and is usually transmitted through personal supervision.

The transmission of partners' knowledge to associates also gives PSFs more economic leverage. By making their knowledge and reputation available to employed associates, partners generate profits while not directly undertaking client work. Partners can then spend time generating future business or managing the firm while juniors work on client assignments, where they are charged out above their total employment cost. Thus, leverage sustains the basic division of labor between associates and partners in the professional firm and underpins the profits to partners.

The organizational mechanism which focuses leverage, innovation and performance is the *team*. Teams are generally shaped like pyramids, the width of whose base reflects the leverage ratio of partners to associates and, in turn, the strategic positioning of the firm. Firms that position themselves for the delivery of high-volume, standardized services that rely on codified knowledge predominantly use highly leveraged teams, and their pyramids are in consequence broadly-based. Firms geared towards more innovative customised services, for which personal experience plays a dominant role, tend to have a narrower base of associates per partner.

Fee billing arrangements are an important part of the monitoring and incentive systems in professional service firms, as the attainment of specific billing targets forms an important part of promotion to partner decisions. However, fee billing arrangements also have an important bearing on firms' ability to innovate. Generally, firms seek to deploy associates to the maximum of their billable hours. The challenge for innovation, however, is to balance immediate high utilization levels against the need to explore and develop new knowledge – which depends to a greater extent on non-billable activity.

THE SHIFT FROM A PYRAMID-SHAPED STRUCTURE OF PSF TEAMS TOWARDS A MORE DIAMOND-SHAPED STRUCTURE FOSTERS INNOVATION BY JUNIOR STAFF

THE IMPACT OF CHANGING CAREER STRUCTURES ON THE **CAPACITY FOR INNOVATION**

Changing the career model at the core of the PSF affects the surrounding elements of the organizing model and ultimately the firm's capacity for innovation. With the introduction of new career structures, innovation may springs from new sources in the organization, as entrepreneurial thinking and commitment to innovation trickle down the organizational hierarchy. The various implications of the new career model for PSF innovation are shown in figure 2.

SHIFTING INCENTIVES

Paradoxically, the introduction of permanent alternatives to partnership and the sharper definition of criteria for those positions highlight more clearly what it takes to make partner. Rather than technical excellence, the capacity to generate new business becomes the sine qua non of partner selection. At the same time, technical experts with a considerable transaction track-record are rewarded more explicitly for sharing their expertise and experience within the firm. This shift in incentives also re-shuffles the pack for junior professionals. Those who aspire to partnership – and those are still plenty – need to develop and demonstrate their business acumen and ability to innovate. As a senior associate's 'book' of clients is usually taken as an indicator of their revenue generating potential, they have a strong incentive to build a committed client base. Merely exploiting established solutions is unlikely to achieve that. Therefore, they are more motivated to explore innovative ways of solving their clients' problems and convincing them that their current and future needs will be well served. They are able to be more innovative because new career models also extend leverage.

EXTENDED LEVERAGE

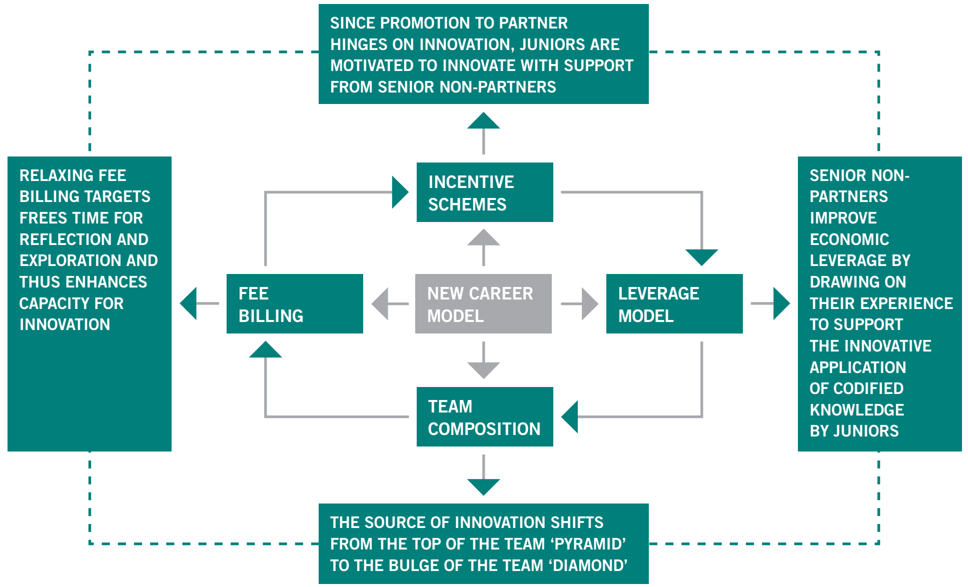
New career structures increase the need, but also the ability of PSFs to leverage their experience and knowledge. On the one hand, permanent, non-partnered staff need to be 'fed' challenging problems that stretch them intellectually and cover their relatively high compensation. Hence, partners need to find more challenging work that requires the exploration of new applications for existing senior knowledge and can be charged out at high rates. On the other hand, partners have more time to win cutting-edge business, as talented non-partnered employees have the requisite 'know what' and 'know how' for innovative service delivery and are less reliant on partner input.

'DIAMOND' TEAMS

The new career model generates a shift from the traditional pyramid-shaped structure of PSF teams towards a more diamond-shaped structure. This shift fosters innovation not only by partners, but also by junior staff. The availability of larger numbers of non-partnered seniors in these teams means that more junior associates can access their rich experiential knowledge more readily. As former fee-earning lawyers, Professional Support Lawyers can not only catalogue precedents and documents but also assist in their application and adaptation for re-use. This is particularly helpful where especially complex and abstract knowledge needs translating into innovative services.

The introduction of permanent positions in experience-based practice groups results, therefore, in a double benefit: it meets the career needs of technically excellent employees

FIGURE 2: THE IMPLICATIONS OF THE NEW CAREER MODEL FOR INNOVATION



who nevertheless lack the skills to progress to partner, but it also creates a knowledge structure that makes tacit, project-based experience more widely available to the organization. In combination, shifting incentives, extended leverage and 'diamond-shaped' teams move the motivation and capacity for innovation down the organizational hierarchy.

THE IMPORTANCE OF WORKING OFF THE CLOCK

Innovation is more likely to emerge when professionals are not constrained by the utilization targets that underpin traditional fee billing. Traditional practice favoured the billable exploitation of existing knowledge over the 'down-time' necessary to reflect on experience and generate innovations. However, senior non-partner professionals often combine strong technical expertise with several years' experience of working on client transactions. They operate at the frontiers of professional know-how using a combination of formal knowledge and firm- or practice-specific know-how to resolve particular client problems. Working 'off the clock', exempt from the billing pressures that constrain the colleagues they serve, such senior staff can themselves constitute an important source of innovation. They can explore new ways of thinking and drive more profound innovations that are unrelated to existing client problems, but may open new opportunities for future services.

Thus, by developing new salaried roles not driven by immediate billing targets, firms create a 'win-win' situation, meeting their employees' wishes for better work-life balance and creating greater capacity to innovate. The more firms invest in non-billable time and support the development of know-how, the more they are embedding innovation within the firm.

These developments may herald the introduction of an R&D capacity in PSFs, akin to that found in manufacturing firms. While innovation in legal PSFs has traditionally occurred on-the-job as individual professionals responded to client demands, innovation may now become an independent function in these firms, one staffed by professionals who have the same credentials as those applying their expertise.

CONCLUSION

Novak Druce Centre research indicates that the traditional up-or-out promotion system in professional service firms is undergoing significant transformation in favour of a new, more holistic career model. This leads to a shift in the structure of teams in professional service firms, from a pyramid-shaped to a more diamond-shaped structure. The new team composition, in turn, has implications for PSFs' capacity for innovation.

Most significantly, the new model suggests that innovation may now spring from different places in the professional service firm. Entrepreneurial mindsets of 'getting the deal done' for the client will increasingly govern practice lower down on the ladder, making innovation more pervasive in the firm, rather than remaining the prerogative of the upper echelons. If business-generating ability rather than technical excellence becomes the key characteristic of partners, then young associates will strive to acquire and demonstrate this skill. In the case of non-partner technical experts who have accrued considerable transactional expertise, their motivation and ability to innovate will also increase significantly – which will help justify their high remuneration costs.

A combination of three elements – requirement, motivation and the ability to innovate – jointly determines a firm's innovative capacity. Staff that are motivated and able to innovate, but not required to do so due to the nature of their clients and assignments, are just as unlikely to innovate as those that lack ability or motivation. Conversely, a favourable combination of requirement, motivation and ability in the wake of the new career model outlined here is likely to enhance markedly the capacity for innovation, and shift the focus of innovation from the apex of the firm's 'pyramid' to the heart of the emerging organizational 'diamond'.

The Insights series aims to provide accessible summaries of recent research by members and associates of the Novak Druce Centre for Professional Service Firms at the Saïd Business School, University of Oxford. Each Insight focuses on a particular issue in the management of professional service firms and offers a fresh, up-to-date reading of this issue.

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