Lateral Partner Compensation

By James D. Cotterman

"YOU DID WHAT?!"

Catherine Applewood is on her way to a management committee meeting. She has just concluded negotiations that will bring an internationally recognized capital markets partner, and her entire team, from one of the world's most venerated law firms to her rising international firm. This was once thought impossible, the decampment of a department head from a venerated law firm where departure usually only occurs by death or retirement to what is admittedly a scrappy, but rising, firm out of the second tier. The news will reverberate throughout the international bar.

But Catherine's focus today is how to navigate her own management committee and her colleague James Timmons. James is the firm's intense, top business producer. His practice and performance is on par with the highly regarded lateral they are seeking. By all measures, James is very well and appropriately paid by his firm. But now Catherine is about to announce the successful negotiation that they had all hoped would catapult their firm into the top tier. The news will be roundly celebrated. At least until she informs them of the special deal that success required. The compensation package of loans, guarantees, and incentives is outside what any other partner has ever received, either in size or complexity. And Catherine is well aware of what will immediately follow from James: "You did what?!" And now a new negotiation is about to begin…

THE MARKET

This is an example of the type of conversation and the sorts of actions that punctuate the lateral partner market – a market that is currently driving a large portion of law firm growth. Market share is acquired, one partner, one team, one office, and sometimes one firm at a time.

Demand measured in aggregate billable hours has been largely flat across the profession since the recent recession, with a perfect storm of forces that at best will likely continue in the foreseeable future, and at worst signals a possible catastrophic overcapacity of private practice lawyers.[1] Those forces include client insourcing, alternative service providers (e.g. e-discovery and document review firms), technology proficiency coupled with other efficiency initiatives, and artificial intelligence (machine learning, analytics, and a cohort of other advanced disruptive innovations).

Thus, firms venture out into the lateral market to lure talented partners who have clients in tow. Although surveys indicate that firm leaders are less than satisfied with the results of this approach, the incessant need to grow revenue or market share slows for no adverse fact. Partners without clients are left out of this lucrative free agency market. Large client portables are the required and not so secret handshake for admission onto the trading floor. The trades appear to be less about platform – scale or scope of offerings – but are more akin to Moneyball.

Each firm must decide how aggressive it wants to be in the lateral market. And with that how much change it wants to accept in its culture. As we will explore below, there are thoughtful practices that can assist a firm in making better decisions, whatever risk tolerance is selected.

THE LOOKOUT BLOCK

In the opening, I described Catherine's concern about her colleague James' reaction. In many firms, the compensation committees are the ones left to deal with the fallout and complications arising out of the premiums paid to laterals. A compensation committee member once described it to me as the law firm equivalent to the "lookout block" in football.[2] The deal is done and now the compensation committee has to manage its way through the consequences.

Thus, two important best practices in partner compensation – internal equity (Pay Proportional to Performance®) and external competitiveness (effectively managing departure risk) – each exert tension on the other. The current state of market pressure is stretching proportionality concepts almost beyond recognition.

It is common for decision models to have factors that compete with each other. That is why a thoughtfully conceived priority decision model is important. The long view believes that Pay Proportional to Performance® is prioritized over making the deal. However, the short view holds the opposite to be true – making the deal is paramount, overshadowing the consequences of not maintaining internal equity.

Let's look at an example more typical than the article's opening game-changing event:

- **Firm profitability factors**: $200,000 per timekeeper overhead and typical market levels of profitability on a portfolio of work done by others;
- **Incumbent**: $600,000 working production and $2,400,000 business generation; will likely earn between $750,000 and $850,000 – arguably higher or lower rational amounts are possible, but this is the most likely range for these profitability factors;
- **Lateral**: Same performance factors as the incumbent above, but will likely be offered $850,000 to $1,000,000.

There we have it. The compensation committee has to deal with two consequences of the lateral premium. In the short term, their need to protect against departure risk by elevating their incumbent and highly marketable partner's compensation is as intense as James' reaction to Catherine's description of the lateral's deal. Taking the longer view, they must also consider the cultural and economic fall-out from an expanded compensation spread that has the potential to disrupt internal cooperation and collaboration if not addressed adequately.

THE SOLUTIONS

Each firm has its own approach to making pay decisions for its partners. Surveys categorize various compensation methods, but each firm infuses any particular method with its own style and often its own vocabulary. It is important to realize that an incoming lateral will want to understand how it's done there and how he or she will be treated within this regimen. Walking the lateral through the process using the lateral's attributes and how his or her performance fits into the firm's decisions will add a level of trust and collaboration to the process. Often, an interim or transitional approach will be tailored to integrate the lateral partner into the firm.

But the real work of making a smart decision begins much earlier. Before compensation can be structured, the committee must have a solid understanding of the economics of the deal. Many law firms need to add more thorough financial due diligence about the lateral's past performance and likely future performance to their screening.[3] All too often the deal is based on past performance alone, assuming that past results will automatically be replicated going forward. Unfortunately, this is a risky assumption for the acquiring firm to accept.

Completing the economic due diligence should be a collaborative process between the lateral and the acquiring firm. We recommend three-year retrospective and prospective timeframes. This six-year span is short enough to be doable and long enough to be meaningfully informative. The firm can involve internal resources to test

the lateral's assumptions, such as their own planning group and partners with similar practices, clients, and markets.

Using the same three-year horizon as in the due diligence, the firm then should model reasonable financial expectations, including the transaction ramp up, for when the lateral joins. Confidence intervals built around a most likely case will illustrate possible better or worse outcomes. If the firm builds a quarterly based model, it will also establish milestones to use for monitoring progress later on. Such models are built on a variety of time-sensitive metrics, including billable hours, recorded time value, billing cycles and collection cycles, and use of retainers. Other critical factors include:

- Whether existing work comes on board (with or without WIP and AR) or stays with the predecessor firm;
- How much of the lateral's team will come from the predecessor firm, and how much will be supplied by the acquiring firm; and,
- Infrastructure investments required, including staff, technology, space, and costs advanced (Note: this is often a shock if the laterals are IP prosecutors and the acquirer is not accustomed to IP business models).

The firm's culture, the degree of interdependency among practices, any existing cost allocation model, the strategic importance of the deal, and the relative strength of the parties will all affect how transaction costs are handled. A very good starting point that might serve well is to share those costs across all equity partners, all lawyers, or all timekeepers.

Once this review is done there is a basis upon which to construct a compensation offer that is fair, balanced, and defensible. It is generally desirable to fully integrate lateral partners into the ethos, culture, and arrangements of the acquiring firm. This means that the offer ought to be based on, or at least be translatable into, the processes and philosophies underlying the firm's current partner compensation program.[4]

Because the lateral comes into the new firm without knowing the lay of the land, the topic of a guarantee will understandably be put on the table. The law firm should pivot from guarantees to assurances. They can reach back to the financial model and discuss the compensation in terms of "if you do this, we will do that," considering what compensation would look like if the best or worst case projections (the confidence intervals) materialized and thoroughly exploring these scenarios with the lateral.

Base compensation should be adequate, but possibly a bit more conservative than what fully integrated partners receive. This is to better protect the firm against the modeled downside economics. In return, the lateral should be offered a catch up option that the regular partners would not have. This might be a base of 50 percent of expected compensation with quarterly milestone payments that take the lateral up to 65 or 70 percent of expected compensation.[5]

Now back to the lookout block and our example for a moment. The compensation committee must be mindful of internal equity. Rather than go for the $1,000,000 premium to seal the deal, they should set a smaller premium that does not disrupt, or disrupt as much, internal harmony. The lateral's success is likely dependent on the goodwill and cooperation of the firm's existing partners – the newcomer doesn't need a target on his or her back. Seeking non-economic glue – environment, esprit-de-corps, whatever internally motivates this individual – will be more effective to attract and bind the lateral to the firm. Money is weak glue, as is exhibited in the serial moves by some lateral partners seeking ever higher bids.

How closely is the offer linked to how well the rest of the firm does? How much sharing will there be initially in the up- and down-side in each other's practice results? These can be points of serious contention when one party or the other gets a windfall and the other party is left on the sidelines, even if the potential outcome was negotiated in good faith beforehand. The consequences I have observed in these circumstances are significant and should be avoided for the health of a long-term relationship. Firms should take a long view with the lateral and the rest of their

partners. A perfect example of this occurred recently where a lateral watched his partners celebrate enormous distributions from a windfall developed and earned prior to his arrival. While economically rational to exclude the lateral, the emotional cost was substantial.

The final element of the compensation offer is how quickly the lateral will integrate into the ongoing program. This assumes that the lateral hire is intended to integrate. If full integration is the desired result, then it should be pursued purposefully with a plan of action and a two- to three-year timeline, if at all possible. This means fully integrating into a single partnership quickly and specifically outlining what this deal does today, and what it is hoped to do three to five years out.

Compensating laterals is made difficult by poor due diligence, insufficient financial modeling, and the premiums driven by a hyper-active market. While a firm may not be able to affect the market, it can choose how to react to the market premiums. And it retains complete control over the thoroughness of its screening processes. Eliminating the risks associated with these deals is not possible, but the risks can be mitigated by smart processes and fair compensation planning.

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REFERENCES

1. *2016 Law Firms In Transitions*, Altman Weil, Inc. Page 31: 59 percent of respondents indicated that overcapacity is diluting their firm's overall profitability. For those firms over 250 lawyers, the problem is experienced by 75 percent of the respondents. And, on page 34, 96 percent responded affirmatively that they have underperforming lawyers. So one could argue that overcapacity is already upon us.

2. A look out block in football is when the lineman misses his blocking assignment and yells back to the quarterback, "Lookout!"

3. And although this is not part of the financial due diligence, please do a thorough credentialing review on all professional hires. While common in the medical field, it is apparently rare among law firms and has caused some acute distress when issues have arisen.

4. There are special situations where this is not the case and the lateral is really an adjunct to the firm ("of counsel") even if the title given and marketed suggests otherwise. Under these situations, it is perfectly acceptable to have a different arrangement philosophically from that used internally among the partners.

5. This assumes that the firm's regular compensation program pays out 65–70 percent of total compensation in base compensation.