FROM AMERICAN LAWYER MEDIA

Law Firm Inc.

IDEAS & INNOVATIONS FOR FIRM MANAGEMENT • NOVEMBER/DECEMBER 2006

ALM

Ops

Richard Gary
ON MANAGEMENT

Lateral Partners

Are they worth it?

One thing that's become readily apparent about the business of practicing law is that growth is essential to long-term success. And if law firm leaders have learned anything in the past 10 years, it's that lateral hiring is essential to growth.

According to the most recent Lateral Report in *The American Lawyer* (February), there have been an average of 2,336 lateral partner moves for the last three reporting periods. The Lateral Report tracks partner arrivals and departures during a 12-month period ending September 30 of each year. This is a powerful number that reflects an industrywide practice, and not a popular fad.

But lateral partners are both costly and risky. And if a lateral partner has moved once, there is every possibility he or she will move again. As a C-level executive, can you calculate the true economic cost of lateral partners to your firm? What can you do to minimize their financial impact? And can you eliminate the risks they bring with them?

Why and How

Strategic Justification. All law firm leaders have their firm's best long-term interests in mind when they go into the lateral market. And lateral partners can have a significant impact by, for example:

• Strengthening a brand-name practice by adding depth or breadth

• Filling a gap in an office or practice group

• Helping your firm gain access to a client or industry sector

Cultural Fit. It's also very important to find people who will blend seamlessly into your firm's culture. Many firms extend offers to a lateral candidate only after the individual has met all of the partners in the candidate's practice area and office, and still others require that a candidate visit every office and have the opportunity to meet every partner before a formal offer is extended.

Due Diligence. Even though a candidate meets your firm's strategic and cultural criteria, it's critical that you understand why the candidate is prepared to leave his or her law firm and relocate to yours. It's human nature for a candidate to tailor the explanation to fit your criteria, but it's good business for you to be skeptical and to determine, as best you can, the candidate's true motivation. For example: 1) Has the candidate's practice slipped in the recent past? 2) Has he or she been the subject of a professional liability claim?, or 3) Has an important client severed its relationship with the candidate or been acquired by another company?

The answers to these questions can be obtained only by conducting extensive due diligence, including in-depth reference checks and completion of a written questionnaire by the candidate.

Sure, you're trying to attract the candidate to your firm. But your principal obligation is to serve the best interests of your firm rather than the candidate. Admittedly, it can be difficult to find the right balance between these competing considerations. As a C-level executive, consider that you may be able to ask questions that partners who are pushing the candidacy are unwilling to address.

How Much Do They Cost?

Lateral partners are very expensive, but how much do they really cost your firm? Here's how to calculate the cash impact of a lateral partner candidacy. Take the example of a lateral candidate with $2 million

Richard Gary is principal of Gary Advisors in Tiburon, Calif., and the former chair of an Am Law 100 firm.
E-mail: rngary@garyadvisors.com.

in portable business, and make these assumptions about expenses:

1) Your firm agrees to a compensation package totaling $500,000 per year.

2) When the candidate joins your firm, you also hire two associates to handle the workload. Each associate costs $200,000 per year in salary and benefits.

3) Your firm's overhead per lawyer (all expenses other than salary and benefit costs) amounts to $250,000 per year.

4) You owe a search firm a fee equal to 30 percent of the total first-year compensation of the partner and each of the associates.

Based on these expense assumptions, your firm's out-of-pocket cash costs during the first year will total about $1,920,000, consisting of:

Partner compensation	**$500,000**
Associate compensation	**400,000**
Attorney overhead	**750,000**
Search fee	**270,000**
Total expenses	**$1,920,000**

Note that if you have underutilized space or administrative staff, you may choose to charge to the new group only direct incremental costs, such as secretarial support and marketing. Under this approach, other costs like space and firmwide staff, which would have been incurred anyway, aren't charged to your lawyers. The problem with this approach is that it overlooks the true overall costs of the group to the firm.

Then to calculate revenue during the first year, make these assumptions:

1. Make the conservative assumption that your new lateral partner and two associates will spend their first two months at your firm working at a 50 percent pace. They'll be preoccupied with transferring files, attending meetings, visiting offices, and acclimating themselves to a new environment. After the first two months, ramp them up to 100 percent.

2. Collection patterns at your firm indicate that invoices issued in any given month will be collected according to the following schedule. (If you feel that these percentages should be reduced to account for realization issues, do so.):

Collection Schedule

Month 1	**15%**
Month 2	**35%**
Month 3	**25%**
Month 4	**10%**
Month 5	**5%**
Month 6	**5%**
Month 7	**5%**

Based on these assumptions, revenue from the candidate's $2 million book of business will total about $1,350,000 during the first year, resulting in a projected $570,000 net cash outflow:

Cash in	**$1,350,000**
Cash out	**1,920,000**
Cumulative net cash in (out)	**($ 570,000)**

After the first year, with revenues attributable to the $2 million portable book of business running at about $167,000 per month and expenses (including compensation) running at about $137,000 per month, it will take another 20 months or so — well into the partner's third year with the firm — before you reach the cash break-even point.

> "Can you calculate the true economic cost of lateral partners?"

How to Mitigate the Cost

There are a number of steps that your firm can take to soften the financial impact of lateral partner candidacies:

- Utilize existing administrative resources to support the lateral group's needs.
- Negotiate with headhunters to extend the period for payment of search fees.
- Structure the partner compensation arrangement so that profit distributions are pushed out to a time when the new partner's revenue stream becomes steady, most likely about six months after he or she joins the firm.

As a C-level executive, you can play a unique role here, introducing a sense of realism into a recruitment process that may well have taken on a life of its own among partners advocating the candidacy.

The Risk

Many lateral partners meet or exceed the goals set for them by their new firms. This is especially true in cases where candidates have been forced to seek new homes because their former firms dissolved. Absent special circumstances, these partners would have been happy to remain at their former firms for the balance of their careers. And the same is often true in cases where qualified candidates have been recruited to meet a specific strategic need.

At the same time, many lateral partners fail to meet their new firms' expectations. They fail to produce the expected synergies, or they fail to deliver the promised book of portable business. In these cases, the adverse financial impact is magnified.

And it is the experience of some firms that lateral partners produce a disproportionate number of professional liability claims. Whether or not this is attributable to the laterals themselves — or to a failure of destination firms to conduct adequate due diligence — is anyone's guess. Firms can become so caught up in the recruiting process that they neglect to analyze a candidate's client list as carefully as they would, if an existing partner introduced the same clients to the firm.

Lateral recruitment is time-consuming, energy-intensive, and costly. Done correctly, with an emphasis on finding good people that meet a clear strategic need, it can provide important, long-term benefits to your firm. But don't be misled into thinking it is a panacea. Make sure that those involved in making a lateral hiring decision are being realistic about how long it will take your firm to recoup its investment. LFI