

## Managing Expectations: Compensating Unique Lateral Partners

By Gerry Riskin

Occasionally firms are presented with a unique opportunity to attract a senior in-house lawyer or governmental official as a lateral partner. If such a person becomes successful, the rewards to the firm can be staggering. But the failure rate of lawyers who intend to build a practice from scratch, regardless of their credentials, is high. It is precisely this potential high risk return that often causes firms to make compensation offers to these laterals — based as much on emotion as any rational thought process.

Normally, setting compensation for lateral partners is a fairly easy function. Since the motivating factor for bringing in most laterals is obtaining their client base, deciding how much to compensate them typically involves determining how much of the billings of the lateral are portable; figuring out how much that is worth in your firm's compensation system; and deciding how much above that amount you are willing to stretch to attract the person. There is a lot of subjectivity in such decisions but it is always based on an identifiable expectation of what the lateral brings to the firm. With lateral candidates who are not currently in the private practice of law, the process becomes even more subjective and, unfortunately, often requires a firm to involve themselves in some level of a bidding war.

### A Case Study

Recently a client asked us to help them think about the compensation of a specific lateral candidate they were considering. I have altered the facts to maintain confidentiality and the client has approved our writing about the situation with the altered facts. The lateral is a lawyer coming out of a Federal regulatory agency. The candidate's entire career has been spent in government and the last 14 years have been spent in this agency, during which he developed a very high profile among legislators, members of the industries the agency regulates and the news media. Without a doubt, this guy knows everybody in these very specific industries and appears to be held in very high regard for his knowledge and skill in building working coalitions. He has prepared a very aggressive business plan that he believes will develop into a \$3 to \$4 million practice within a couple of years. The firm's strategic plan is strongly based on a focus on two of the industries this lateral is involved in and it is the belief of some of the partners that bringing this candidate in could solidify their practice and allow them to effectively compete with the Washington firms that dominate client representations before the agency.

Apparently, several of these Washington firms also have an interest in this candidate and are supposedly talking compensation approaching \$1 million. While it seems logical that all of the "players" in this practice would be interested in this person, there is no way to verify the information the candidate is supplying about what competitors are offering.

### A Thought Process

When an actual lateral opportunity like the one described above presents itself to a firm, typically there are time constraints involved and the opportunity is usually championed by a proponent from within the law firm who tends to focus on the best case scenario and equally ignores the risks.

Scenario Planning. When dealing with laterals, especially those without a clear client base and track record, it makes sense to consider a number of objective factors including the client originations the lateral will produce, originations that will accrue to other attorneys in the firm as a direct or in-direct result of the lateral, and the value of the billed work of the lateral as an attorney, regardless of whether it is for his or her client or someone else's. We suggest this be viewed from at least four different scenarios:

- Minimum First Year Success – the level of performance that would meet the minimum expectations of the firm, and below which would cause the lateral to be considered a failure.
- Mature Year Mendoza Line\* – the on-going level of performance once the lateral has settled in, and below which he or she would be considered a failure.
- Mature Year Likely Scenario – the level of performance that is viewed as being the most likely end result and, typically, the level on which a given deal's economics are built.
- Home Run – not necessarily the maximum but the level of mature year performance at which the firm would clearly describe the lateral as a "home run."

The following matrix is an example of possible responses for the lateral in the case study:

**Return on Investment.** The purpose of the analysis above is simply to consider and come to internal agreement on what the reasonable expectations are for the lateral. The baseline issue, however, is the maximum compensation the firm is prepared to pay to accomplish the various levels. Since most law firms in the U.S. operate on a cash basis, this really requires a cash flow analysis to calculate how much money is at risk at any given time for the various scenarios that have been identified. Using this analysis, one can project the maximum cash flow at risk based on the scenarios and project a reasonable required return on that amount to justify the investment. A common standard for return on investment is, by the third year, 15 percent of the annual revenues originated as the return to the partnership after the lateral's compensation, plus a cumulative return of 25 percent on the maximum negative cash flow incurred over the three years. That, of course, is tempered by the subjective benefits of the lateral.

**What the Market Will Bear.** But, when all is said and done, sometimes it makes sense to take a deep breath and look at the issue on the basis of what is realistic – not only realistic for your firm, but also for the firms that are competing for the lateral candidate. It is rare — and culturally difficult — for a law firm to bring in a lateral whose earnings will be substantially higher than the current highest paid partner, regardless of how outstanding the opportunity may be. The pressure intensifies when time constraints imposed by the lateral's situation require a firm to make decisions in a compressed time period. For these reasons, as part of their strategic planning discussions and implementation, firms often engage in discussions about the introduction of possible laterals, and the potential positive and negative ramifications they will have on the partnership and compensation structures. While these discussions are hard to have in the abstract, they do permit firms to abbreviate the discussion time required when an actual lateral is available. Furthermore, it gives the firms leaders an idea of the level of acceptance for any “above bracket” compensation.

At the same time, the firm needs to be looking with skepticism at information presented by the candidate as to what competing firms are offering. As skilled as lawyers are in negotiating on behalf of their clients, they often become passive and accepting when negotiating with laterals. If the firm across the street is offering \$200,000 more than you are, one of you has drastically misjudged the potential risk and reward of the candidate or the candidate is embellishing the offer.

**Structure of the Compensation Package.** For some firms a pivotal issue is whether the lateral joins the firm as an equity or non-equity partner, or shareholder. Sometimes firms are concerned that it will be difficult to attract a candidate unless equity partnership is offered. In fact, it would be rare for a firm to invite a lateral without an established and verifiable book of business to join a firm as an equity partner or shareholder. The firm needs the means of reversing its decision quickly and without great difficulty if the lateral is unable to produce the intended result or, at least a way of “stopping the bleeding.” Typically, non-equity status permits a firm to create flexible compensation that ties to the success of the candidate.

A common means of compensation is to set up a basic draw with trigger points for increases or decreases. For example, for the candidate in the case study, a compensation agreement might include:

- Basic draw (salary) of \$35,000 per month for a one year contract.
- Review after six months with the right to cancel if there is substantial failure against expectations. Draw may also be increased at six month point in recognition of success.
- Bonus compensation of 20 percent of originations in excess of \$1.2 million in originations.
- Consideration for equity partnership or shareholdership at the end of the first full year with the firm.

Another option that firms use is an “earn-out” that establishes a projected cash flow for the originations of the lateral, including compensation, and provides the shareholder increased salary draws based upon the fulfillment of the projects. The key for most firm structuring of non-equity compensation deals with laterals (particularly those coming from corporate or government positions) is to limit the firm's downside while providing the lateral with a meaningful incentive. Clearly, the greater the downside risk avoidance for the firm, the larger the incentive required for the lateral.

**Due Diligence and Risks.** In fairness, I have to advise you that our experience has not been good in seeing corporate general counsel and government officials succeed as practicing lawyers. With lawyers coming out of corporations, the likelihood of success seems to decline with the size of the corporation the candidate is leaving, particularly if the individual is leaving with a “package” that removes most of their financial incentive to build a practice. Inside corporate counsel entering the private practice of law seem to either work out beautifully because they really understand what clients want and buy, and have great regulatory relationships and provide access to potential clients as a result of their previous position, or they work out miserably because they have been away from the “real” practice of law for too long, are technically not up to speed and have become lazy.

**Bottom Line**

Of course, all of this analysis goes out the window if the lawyer is a long-serving elected official or a former presidential candidate. On balance, our observation is that about one-third of lawyers coming out of government or corporate legal departments succeed in private practice and maybe 10 percent approach the level of business development that their hiring was based upon.

Bringing in a lateral lawyer who is currently not in private practice is a gamble and can result in a huge win — but more often does not. Make sure you understand the odds as you consider the decision.

---

\*The Mendoza Line refers to Mario Mendoza who, in 1979 with the Pirates, had a batting average of .198. The line refers to how bad you can be and still play major league baseball.