



Calculated Lateral Growth: Balancing the Risk Reward Ratio

As most managing partners will attest, lateral hiring presents both opportunities – and risks. In light of limited growth in client demand for services, law firms are keenly focused on growth via laterals as a tool to increase – or even maintain – market share. Simultaneously, numerous firms are also focused on eliminating underperforming partners. These combined forces have heightened levels of lateral activity in terms of both firms seeking lateral partners, and partners seeking new opportunities. Discerning which individuals offer a strong practice, financial and cultural fit can be challenging, and, too often, firms hire lateral partners who either do not deliver what they promised in the recruiting process, or simply do not fit within the firm's practice and/or culture.

First, the Risks...

Firms report that success in lateral hiring generally ranges between 40-60% depending on the firm, the market, and how you measure success. For some laterals, success may mean simply breaking even, so the proportion of laterals who meet or exceed expectations can be lower than 40%.

Aside from being a costly investment, failed laterals can threaten the stability of a partnership. Firms who add laterals without a strategic focus often form offices or practices which are a loose coalition of practitioners - a mix of lawyers with disconnected clients, uneven quality or economics, or conflicting priorities. Numerous firms also over-compensate laterals which often creates tension among homegrown partners. A pattern of lateral failures can lead to underperformance and the departure of valued partners who are fed up with costly lateral failures, which in turn contributes to partnership instability.

The Reward?

In spite of the clear risks, lateral hiring can be a critical growth tool for law firms. Successful lateral hires can improve a firm's competitive position through enhanced geographic growth, greater practice depth, client access, increased profitability, and a higher profile. Given challenges with organic growth and competition for clients, laterals offer access to talent and clients which are often otherwise unavailable to a firm without a merger.

So, how should firm leaders go about balancing the risk and reward inherent in lateral hiring?

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Effectively balancing the risk and reward inherent in lateral growth starts with adhering to several fundamental approaches in hiring:

- ***Focused Investment:*** Lateral growth is an expensive proposition, and as such, firms simply cannot grow in all practices and geographies simultaneously. Successful lateral hiring requires prioritizing investments in candidates who offer the greatest strategic benefit and market impact. To accomplish this, firms must focus lateral hiring on select practices, geographies or client industries which measurably improve the firm's overall competitive position and present the highest priority growth areas for the firm as a whole. Once priorities have been set, firms must then commit to a proactive search for laterals meeting those criteria, as reactive hiring generally leads to less focus and more acceptance of whoever shows up on a firm's doorstep.
- ***Clear Fit Requirements and a Thorough Due Diligence 'Machine':*** Successful lateral growth also requires focusing investments on lawyers who align with the firm's current and desired client segments, value position (e.g., billing rates/pricing), resource requirements (e.g., staffing/overhead), and culture. Those not presenting a strong fit should be eliminated quickly in order to avoid wasting scarce firm resources in further discussions and analysis. This requires firms to build efficient filtering systems to assess early on which candidates meet specified practice and

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cultural criteria and then reallocate resources away from those who do not.

Similarly, a robust and clearly defined due diligence process essentially creates a due diligence 'machine' which allows firms to quickly research and process client, financial, background and reputation data on lateral hires. Beyond more routine due diligence steps, particularly strategic firms are focusing efforts on testing the validity of client relationships in the due diligence process. While ethics rules present hurdles in direct outreach to non-shared clients, firms are leveraging personal and professional relationships to research the strength of client connections before hiring. There are even third party due diligence options available which add rigor to the process.

- Scenario Testing: It goes without saying that financial testing of the impact of lateral hires is of critical importance in law firms. The most effective lateral growth models perform multiple scenario tests, based on a range of assumptions relating to practice performance and client mobility. Most firms apply discounting ratios of an estimated 'portable' book of business to assess the impact and break-even point based on more conservative revenue generation scenarios. Discounting ratios may be weighted based on the known portability of select clients, and in some higher opportunity analyses, growth rates are projected based on new client development and existing client expansion opportunities identified in the recruiting process.
- Known Relationships/Connections: Hiring in the corporate world has increasingly become a model based on professional connections. For law firms, we similarly find that the most successful lateral hiring models are ones which leverage professional relationships and connections of current firm members, alumni and clients to identify high caliber candidates and known commodities - the individuals who will deliver the practice and clients promised, who will most successfully integrate into the firm's culture, and who will maintain quality and service standards. These hires benefit from a major advantage – pre-existing respect and business relationships with partners and/or clients which can lead to more rapid integration and growth of their practice.

Many firms active in lateral hiring have had these types of fundamental approaches in place for a number of years. Unfortunately, though, attrition and failure rates continue to negatively impact even those firms with more effective methods of recruiting and vetting lateral candidates. In many cases, the underlying cause behind a failed lateral hire has less to do with the vetting process, and more to do with lateral partner compensation approaches.

Balancing the Risk Reward Ratio

Perhaps the biggest challenge for firms in arriving at a highly successful lateral growth model is partner compensation. The industry's current standard of offering star lateral candidates substantial compensation guarantees has shifted a disproportionate level of risk onto the firm. Candidates often benefit from a 20-30% pay increase by moving between firms and bear no risk in compensation for 18 to 24+ months. This unhealthy and imbalanced risk reward ratio is a root cause of the high lateral failure rates in law firms due to the fact that some clients are simply not as portable as anticipated. Numerous lateral partners who believe that they will arrive with a book of business end up underperforming relative to their guaranteed compensation. This is often compounded by the relatively short investment horizon in law firms, and among law firm partners. One year of underperformance can result in the perception of failure which then leads to partners being less willing to try to integrate the lateral into their clients and practices.

Balancing the risk reward ratio in lateral hiring requires firms to more evenly distribute the risk and the reward between the lateral and the firm. This may take the form of a compensation arrangement which provides for a lower 'floor' in guaranteed compensation, but greater upside potential. This can be structured based on thresholds of performance. For example, firms start by establishing a conservative base or floor and compensation above the floor requires exceeding specific financial targets set at multiple tiers, with increasing profit sharing ratios as performance moves higher. Premium performance-based bonuses can provide a competitive 'kicker' for particularly sought-after candidates, which enable the lateral to achieve superior compensation in their initial year or two relative to competitor offers. While some candidates prefer the safety of a model with higher guaranteed compensation/lower upside potential, we generally find lateral partners who achieve the greatest success in bringing over substantial work and clients are those most willing to accept risk in return for a higher reward.

Successful lateral hires can enable a firm to increase market share, rebuild an anemic office, improve profitability, grow high value clients, and more. Unfortunately, though, too many laterals fail to deliver these superior outcomes and end up being

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costly mistakes. A first step in a successful lateral hiring model is establishing fundamental approaches which ensure focused growth, increased likelihood of fit, and efficient and thorough vetting. Beyond the fundamentals, firms must also seek to arrive at a more balanced risk reward ratio where the firm and the lateral truly *partner* in a way which will lead to longer-term success.

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