# A COLLECTION OF FAIRFAX INSIGHTS

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# CONTENTS

# COMPENSATION FOR LEADERSHIP

Firms have worked hard in recent years to fine tune their partner compensation systems, clarifying performance expectations for partners and improving the metrics and other types and sources of input considered. Yet compensation for the key leader or leaders (such as a full-time Chairman and/or Managing Partner) remains surprisingly unstructured in many firms, and is almost an afterthought. This has led to consternation on both sides – leaders feeling underappreciated, and partners questioning the value the leaders are delivering to the firm. Because firm leaders are often among the highest contributing and highest paid partners, it is important that firms do their best to get it right.

In our recent work with firms, and based on three recent benchmarking surveys on governance and related compensation issues among leading law firms, we have reached the following conclusions (among others) about compensation for firm leadership:

- Performance expectations for firm leaders are often undefined, and there are rarely agreed upon goals and objectives for the year.
- Performance assessments at year end tend to be superficial even if there is a robust process in place for other partners.
- Firm performance, other than to the extent that it impacts overall profitability and point value, is rarely considered in assessing leader performance.
- Compensation setting is often based on a leader's historic compensation levels as a practicing lawyer rather than their value as a leader of the firm.

Firms typically do a good job in spelling out other aspects of leadership, including the selection/election process, the terms and term limits, the broad scope of authority of the roles, the expected time commitment for those not in a full-time leadership role, and even provisions for compensation protection when a partner leaves the leadership position and returns to practice. But performance management and compensation tends to involve far fewer specifics and more trust in the process. While compensation of partners is often as much art as science, we do think there is room to enhance the process for firm leaders.

### Key Areas for Focus

The areas calling for a more robust process fall into four categories: 1) Agreement on goals and objectives, 2) Performance Assessment, 3) Compensation aligned with achievement of goals, and 4) Objectivity of the compensation setting group.

***Agreement on Goals and Objectives.*** While many firms expect partners to prepare annual plans, fewer expect firm leaders to do the same, and fewer still review and agree to those goals. Of course, many leaders do set objectives for themselves as part of their own personal planning process but rarely review those with others. As a result, we sometimes hear partners question what the leaders are doing and whether they are doing the right things, or the most valuable things.

Setting out goals for the year that align with and support the firm's strategy is a critical step all firm leaders should be taking. Those goals should then be reviewed and agreed with the board-level management body. In some firms the agreed goals will be published to the partners so that all have a clear understanding of the priorities for firm leaders for the coming year.

***Performance Assessment.*** The performance assessment of firm leaders needs to be done with the same rigor as that of the rest of the partners. It should start with an assessment of the leader's achievement of the goals set out at the beginning of the year. The assessment should include a self-assessment from the leader, input from the Board/Executive Committee and other key managers in the firm, an assessment of relevant metrics in support of key goals, and possibly feedback from the partners.

The feedback from the Board and partners needs to be weighed appropriately given that being an effective leader of a firm isn't a popularity contest, and the actions a leader must take may necessarily result in some ruffled feathers. In addition, some partners can have unrealistic expectations for the firm's leadership, as well as less than full visibility into all that the leaders do, resulting in feedback that is not fully informed and often overly critical.

Some firms use a scorecard approach to evaluate a leader's contribution, which captures goals and Key Performance Indicators (KPIs) along key dimensions, such as:

| | Strategic Direction | Client Management | Talent Management | Financial Performance | Inspiration/ Leadership |
|---|---|---|---|---|---|
| **Goals** | | | | | |
| **KPIs** | | | | | |

***Compensation Alignment.*** Once the assessment is complete, the results need to be factored in to a leader's compensation determination. Achievement, or not, of key goals should have some bearing on the outcome. In some firms this might be a part of the bonus determination for the leaders. In other firms, it might influence base compensation or levels placement for the coming year. A few firms have an 'at risk component' of compensation for leaders that is dependent on achieving objectives. This latter approach is most similar to what we see in other businesses, but in practice can be difficult for law firms to implement.

The use of firm performance metrics is always an interesting topic when it comes to leader performance and compensation. Often firms wonder if the firm's profit per equity partner performance should be a key metric in determining compensation. While PPEP is indeed important for many firms, it is important to balance that with other metrics that support the key goals. And firm metrics should inform, but not formulaically determine, leader compensation. The danger of relying too heavily on metrics is that it can incentivize maximizing short term profits which can lead to underinvestment in strategic medium and longer term objectives. Finally, unless a leader has a fixed salary, their compensation ultimately is influenced by firm performance through point or share value, as is the case for all partners.

***Compensation Setting Group.*** There needs to be trust in the process for partners to have confidence in the results. In more than a few firms there can be a perception that the compensation committee, or leadership group, is focusing on their own compensation over the partners. Based on our work with firms, this is in fact rarely true, but it is important that partners believe that it isn't true.

The group responsible for determining leader compensation needs to be seen as being fair and objective in their role. If the firm leaders are members of the compensation committee, as they often are, it generally requires establishing a separate process for the leaders. This can be a subset of an independent Board/EC, or a group of former Board/EC members, or a subset of the Compensation Committee. It could even be a role for an outside director. In some firms, it is important that the group charged with setting leader compensation completes their process after their own compensation is already set, so that they don't fear consequences for making a tough decision if one needs to be made.

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Increasing the clarity around the role, performance and compensation of firm leaders will serve both the leaders and the firm better. For the leader, it is an opportunity to confirm his/her priorities and continue to maintain the trust of the partnership. For the firm, it helps to ensure that the firm is getting the best from its leaders and paying them commensurately.

# THE EVOLUTION OF PARTNER PEER REVIEW

Law firms have relied on feedback from other partners as a factor in evaluating partner contributions and setting compensation for many years. Some firms asked all partners to rank others or even to make compensation recommendations. However, as firms grew in size and geographic spread, it became a less important factor, and in many firms faded away entirely.

As partner feedback models have become more sophisticated, the industry has seen a resurgence and reinvention of the peer review process. Firms are exploring new ways to gather information on partner contributions. The reinvention of the traditional peer review approach has arisen out of a desire to gather more comprehensive and well-rounded information about the more subtle ways in which partners contribute, particularly in areas which may not be readily or easily observed based on quantitative data or from the vantage point of centralized firm leadership.

These new forms of peer review are largely centered on gathering broader partner input on other partners' contributions in several high value and difficult to measure areas, including:

**Alignment with the firm's core values:** Many firms have invested substantial effort redefining their core values over the past decade. Some firms see their core values as a key differentiator and critical to maintaining their success. In a mid-size or large firm, or a firm with multiple offices, it can be challenging for firm leaders to spend sufficient time with partners to assess whether their behavior is aligned with the firm's core values. Are partners actively reinforcing values associated with diversity, inclusiveness, and professional treatment of staff and lawyers? Peer review processes offer the potential to solicit broader partner input on how partners' behavior is reinforcing or undermining the firm's values statement.

**Commitment to collaboration and teamwork:** Many firms today are taking action to reduce internal competition and to reward collaborative behavior. The peer review process can offer a critical component of gathering broader feedback on partner contributions to building teams, expanding client relationships, opening doors, and leveraging and sharing their personal networks. It can also offer a window into behaviors which undercut teaming and interfere with building a collaborative culture. In some firms the very process of peer review encourages more cooperation among partners because they know their contributions can be commented on in the peer review process.

**Contributions to firm building efforts and strategic initiatives:** Too often, law firms fail to call upon individual partners to play an active role in implementing strategic initiatives in their own practices, or to recognize partners when they do make these efforts. This is in part driven by the difficulty in measuring and capturing smaller or lower profile contributions which may provide a meaningful benefit but are not easily recognizable apart from the day to day practice. Peer review processes open the door for partners to recognize the contributions others are making to important firm building initiatives, which go beyond day-to-day operations.

In each of these three areas, there can be substantial benefit in gathering broader partner input since partner contributions in these areas are not easily quantifiable and can be difficult for management to readily discern without regular exposure. To a degree, law firms are experimenting with an element of 'crowdsourcing' partner feedback through the peer review process, casting a far wider net to gather broader information based on multiple points of exposure and observation.

While a reinvented peer review process offers advantages, there will undoubtedly be firms where peer review runs into hurdles. As in the case of most strategic initiatives, the effectiveness of an adapted peer review process will be determined in large part based on a firm's ability to implement these programs in a way which is viewed as building the partnership, and not building 'big brother'.

So what steps are firms taking to try to ensure the success of their peer review approach?

**Protecting confidentiality:** Whether feedback is solicited in writing or verbally, firms must remain highly committed to protecting the confidentiality of the information received. Partners are less likely to provide honest feedback if they have concerns that the information may be inappropriately relayed or attributed to their peers. In fact, some firms have used their talent management staff or other professionals to gather feedback, to provide a neutral ear.

**Multiple data points:** A key benefit of utilizing broader partner input is the ability to solicit multiple views. Multiple perspectives can also be critical in determining the legitimacy of a set of observations. This enables firms to look for and rely upon general themes in feedback instead of single data points or observations which may be outliers.

**Ensuring validity and currency of the feedback:** Firms want to make sure that feedback from peers is current information rather than based on events from years ago, or the perpetuation of urban legends. Asking for specific feedback on partners who worked on the same matters or clients is one way to ensure a current relationship. Asking for the context on pitches or firm work or other interactions can ensure currency on non-client work.

**Soliciting both positive and constructive feedback:** In order for peer review to offer meaningful benefit, it must be centered on soliciting both accolades as well as concerns. Too often, partner feedback on other partners can focus on the negative. Of course, this feedback is often necessary and valuable to the organization in addressing problematic behavior, and without it, peer review processes can lose a lot of their overall benefit. However, many firms have also seen value in encouraging partners to act as champions for their peers, asking them to observe their colleagues' key contributions or wins. In fact, in firms where partners complete self-evaluation memos that highlight their successes many firms will include the question "Who helped you?" and similarly will ask partners "Who did you help?"

In recognizing the value that others bring to the table, some partners are better able to self-realize the relative value of their own contributions and be more objective about why others are being rewarded. The key to success here is really around ensuring that partners provide both positive and constructive commentary – balancing both the need for improvement among some, with the recognition of strengths among others.

Overall, the evolved peer review processes providing the most value in firms today are aimed at capturing input on select, high value and difficult to measure areas and from multiple sources capable of observing these types of partner contributions on a regular basis. This reinvention of peer review allows firms to gather broader qualitative data about partners - a far more well-rounded perspective - while simultaneously empowering their owners to think more deeply about partner contributions (including their own) and the relative roles that partners play in influencing the firm's success.

# THE CRITICAL LINK BETWEEN MANAGING PEERS AND MANAGING CHANGE IN LAW FIRMS

Change within law firms is notoriously difficult to accomplish. Law firms tend to focus on and manage themselves based on precedent, making new ideas and ways of doing things difficult to adopt. Partnership structures and a high degree of partner autonomy also act as opposing forces to accomplishing change in many firms, where a multitude of stakeholders, a strong consensus orientation, and in some instances, leadership by committee limit a firm's ability to adapt. Through our work with law firms in leading successful change management programs, we have identified multiple key factors in accomplishing change – with one of the most critical being the act of *effectively managing peers.*

While this topic has been discussed for many years, both within the legal industry and outside of it, the notion of 'peer management' in and of itself remains a challenge for most firms. While law firms recognize the need for broader and more empowered leadership roles and responsibilities, many firms still struggle with the role of leaders in managing other partners. There is a clear tension between the need for management of partners as highly valuable assets, and the recognition that partners are owners of the business.

In the context of accomplishing change in law firms, the value and intent behind effectively managing peers is <u>not</u> a typical top down definition of management or aimed at dictating partner thinking or actions. For many law firms, this type of peer management would be highly problematic.

Instead, managing peers in this context is about firm leaders recognizing the need for cultivating support, understanding, engagement, dialogue and buy-in among partners on change efforts (and in all aspects of the firm). It is about defining how leaders communicate with peers and seek to cultivate the understanding, relationships and connections which will enable partners to get behind change efforts. Under this lens, managing peers can be intensely challenging. It is not a simple decision which can be rolled out or communicated. It is an ongoing campaign to solicit input and support from relatively large groups of independent thinkers and trained skeptics.

We often see change efforts fail because too little leadership time and forethought has been invested in considering how best to manage peers in relationship to the change. In these instances, assumptions are made about how partners may or may not react to a change, and too little one on one dialogue occurs between those leading the change and the owners of the business.

So, how do law firm leaders manage peers, and how can they be particularly effective at it?

A first step towards effectively managing peers starts with recognizing that in order to accomplish change, leadership must seek out and communicate with a diverse group of partners operating with a spectrum of views. This means that different approaches will be required for different groups and even individuals. Leaders will need to seek out each group to explain the case for and value of the change and be prepared to address the questions and concerns which are most relevant for that particular set of partners. This step is aimed at winning the hearts and minds of the partners.

By way of example, we often see partners falling into some or all of the following categories: 1) partners most heavily focused on the business, financial and strategic impact of change, 2) partners most heavily focused on the cultural impact and people side of change, or 3) partners comfortable with the status quo and fearful that any change will cause discomfort or jeopardize their own personal priorities. While some partners fall squarely into one of these groupings, many will have characteristics of more than one grouping, and depending on the firm, other nuanced groupings may emerge. By examining the perspective of various categories of partners, we can observe how differing forms of peer management are required. Leaders will need to be prepared to provide proactive communication which will allay concerns and address the issues specific to each group.

1. **Business, Financial, Strategic Impact:** Dialogue with this group tends to require careful analysis of the expenses associated with the change under consideration, potential return on investment or long-term savings, the alignment with the firm's strategy, and how this will move the needle for the firm in terms of long run competitiveness and market position. Leaders should be prepared to show action plans and financials associated with the proposed change.

2. **Cultural and People Impact:** For partners most concerned with the human side of change, leaders must be prepared to demonstrate the alignment of the change with the firm's core values, how the change benefits the firm membership as a whole, and methods for defraying short-term morale issues which may be created by the change.

3. **Status Quo Preservation:** Unfortunately, in many firms where change is pursued less frequently, or where the change being proposed is significant, the status quo group can represent a large number of partners. Individuals in this group are averse to change because they fear it may jeopardize their own comfort level or current clients, practice, compensation, etc. While leaders may not have the bandwidth to manage all of the partners in this category, for vocal change resistors in this group, leaders will need to demonstrate that the status quo is not sustainable and utilize support from key influencers in other categories to message the risks inherent in seeking to preserve 'business as usual.'

For particularly difficult change efforts, managing peers effectively will require these conversations take place with numerous key partners and influencers in the firm. Often times the format will be informal, through one on one meetings and walking the halls. Leaders will need to convey that they are actively listening to concerns while maintaining clarity in the message and direction being set with the change. This is where the truly nuanced nature of effectively managing peers comes into play. Leaders cannot effectively implement change efforts by over-responding to partner pushback. This requires balancing the ability to listen and solicit input, with the need to generate support and cultivate buy-in around the change. A key to achieving this balance lies in conveying both active listening and careful preparation – hearing partners' questions and having thoughtful responses and analyses prepared in anticipation of these types of concerns and reactions.

Managing peers requires cultivating a series of these conversations, over many topics, over many months and forming close ties to peers. To accomplish change in a law firm, leaders must have a strong network of partner relationships, which generates essential partner trust and confidence in overall decision making. This confidence snowballs, enabling partners to more readily support future change efforts which in turn enables the firm to more proactively adapt to changes in the marketplace. Managing peers is a critical tool for firm leaders seeking to influence partner thinking, establish trust, and successfully execute change.

# INCENTIVIZING AND COMPENSATING PARTNERS IN TRANSITION TO RETIREMENT

With demographic shifts reshaping law firm partnerships, many law firms today are struggling with the challenge of how to best reward and motivate partners in transition to retirement. Senior partners in law firms continue to represent a large percentage of the equity partner population, and often they are responsible for generating a disproportionate percentage of revenue and managing major client relationships. Identifying the right approach for how to harness the experience, network of contacts, and contributions of these individuals can be critical to a firm's long-term success or even survival.

Unfortunately, there really are no simple answers to this complex question. In today's environment, partners in transition represent a broad spectrum of contribution levels, and as a result, a single or uniform approach is unlikely to work. It is not uncommon to see firms with two partners with similar expected timeframes for transitioning out of the firm to retirement, but with radically different contribution levels and professional motivations. One may be highly engaged in growing the overall firm, generating substantial client revenue, personally productive and contributing to non-billable firm projects. Whereas, another partner of equal seniority may have a productive practice, but it may be entirely oriented around him/her with little potential for succession because he or she is not engaged in building the firm overall. While both partners may be operating with similar three to four-year time horizons towards retirement and both may have high production and origination statistics, the approach to rewarding and incentivizing these individuals to contribute in ways which most benefit the firm must be customized to reflect their individual situations and personal goals.

In the past, compensating retiring partners was far less complex. First and foremost, there were fewer of them, so these issues arose much less frequently. In addition, many firms tied compensation for partners in transition to a graduated reduction in contribution level. This meant that as partners entered a three to five-year window towards retirement, both their expected contribution level and their compensation would gradually transition down. This approach offered the benefit of supporting a more gradual transition, allowing both the firm and the partner to better manage the financial impact, while simultaneously allowing for implementation of a managed succession plan. In environments where partners operated under this shared expectation of a phased down approach to compensation and commitment level, this method worked well.

However, as firms have migrated towards a greater focus on individual metrics in setting compensation for all partners the dynamic has changed. This shift has impacted the thinking and behavior of senior partners, resulting in some push back on giving up client origination credit and the associated compensation. Even when offered the potential for a non-metrics driven bonus, some major rainmakers have resisted the idea that they would be expected to reduce their involvement in client work and relationships to allow for transition and to align with a graduated reduction in compensation. Other senior partners seem to be seeking to avoid the unavoidable reality of eventual retirement overall.

These partner reactions are likely driven by a simple desire to maximize compensation at the tail end of one's career, or a desire to maintain influence and continue to be seen as a high value, major contributor in the partnership. While perhaps understandable, these self-serving and often sub-conscious desires can interfere with partnership transition and cause succession efforts to fail – while simultaneously, subjecting the firm to more risk, based on a heightened dependency on a growing population of senior rainmakers who may or may not be able to continue to contribute at high levels within a relatively short order.

The solution for firms dealing with these types of transition tensions lies in getting at the heart of an individual's professional aspirations or sources of motivation, as well as his/her unique strengths and critical areas of contribution.

This requires that firms step back and work with partners to define:

1. What each partner as an individual needs to feel professionally satisfied
2. The highest value contributions that each partner offers based on his or her skill set
3. A rewards system and contribution expectation which aligns the two

This is no small feat. Identifying these individual goals, defining contributions, and measuring progress to align incentives in a fair and transparent way is a complex process.

As a first step, firms will need to shift away from a heavily metrics-driven performance monitoring and compensation approach for senior partners. This would be a major departure for firms who report and distribute a broad range of metrics on all partners monthly. It would also result in a separate compensation approach for senior partners, such that their compensation would be set with a different philosophy and criteria than other partners. For partners in transition, firms will need new metrics, which may include measuring actions and results taken based on succession plans or rating the success of expanding or transitioning client relationships. Maintaining and reporting on origination and personal production metrics for senior partners (even if firms seek to tell these partners that their compensation is not dependent on them) will inhibit transition and succession efforts and in some cases, cause firms to fail to capture the true value that a particular senior partner may offer during his or her transition time period.

In addition, effectively aligning a senior partner's transition goals and contributions with a rewards system will require significant one-on-one dialogue and learning about an individual partner's aspirations and contribution potential. Firms will be required to look behind known information about individual partner's past contributions to understand the nuances around their expertise, professional network, and client development skills which may require succession focus and offer potential for further revenue growth under a less conventional definition of partner contribution. Even further, it requires clear communication and follow up to maintain alignment in expectations and contributions after they are initially set.

Of course, these efforts must all be made early on – before retirement is imminent. This requires approaching partners by at least the age of 60 to 62 to conduct initial discussions of their plans and timeline for phase down or retirement. In most instances, firms find that three to five years are required to successfully transition major client relationships to a next generation partner(s). While firms will want to remain flexible in order to address individual partner plans and goals for retirement, a defined and consistent process will be important to help build confidence in the firm's fairness and avoid the potential for any age discrimination claims.

Senior partners in law firms operate as major contributors and the ability to effectively motivate and harness their contributions over the next five to 10 years will mean success or failure for some firms. Customizing rewards systems to align with high value senior partners' unique ambitions and professional strengths will be critical to success.

# TIME TO RETHINK YOUR STAFFING STRUCTURE?

Managing costs has become a priority for most law firms. Law firm support structures today are more efficient than ever before, and this efficiency has increased materially in just the past several years. Overall ratios of support staff to lawyers in large law firms now run in the .8-.9 to 1 range, while ratios in the 1-1.2 range were more typical only a few years ago.

Based on our work with firms and a recent benchmarking study we conducted of a group of large law firms, we know that firms are actively rethinking their staffing models to be more efficient and to provide a more sophisticated level of service to the firm. In addition to lowering administrative staff to lawyer ratios, firms are also hiring professional staff with specialized expertise in areas that didn't exist a few years ago.

## Where are Firms Becoming More Efficient?

The largest pool of support staff in law firms tends to be the legal secretaries. Much of the efficiency gains in recent years has been through improvements in the legal secretary to timekeeper ratios. While some of this is a natural evolution as technology has allowed lawyers to become more self-sufficient, some is also the result of new approaches to secretarial support. Numerous firms have now instituted secretarial teams or pools to support a larger pool of lawyers. The team can spread the workload around more evenly and can cover vacations and extended hours of the day more effectively, thus increasing service levels to the lawyers with a smaller team. Some firms are experimenting with moving the secretarial team off-site, to lower cost space or locations, to further increase efficiencies. This has tended to work best when the team is supporting younger lawyers who are facile with technology. And some firms are creating multiple levels of secretaries so that they can hire lower paid secretarial assistants to do work that requires less skill, reserving the higher value work for the more highly compensated and experienced senior secretaries in a team. In combination with technology advances and training, the ratio of lawyers to secretaries is on the rise (with some firms achieving ratios in the 4 to 5:1 range, and some getting to 8:1 with their associate pool), and firms are far less reliant on secretarial support than ever before.

Firms are also gaining efficiency through increased use of centralized services and off-site centers. For multi-office firms, it is about centralizing the majority of the staff in a particular function in a single office location. While this seems somewhat counterintuitive in today's environment of flexible workplaces and technology that supports remote working, firms find that centralized staffing can provide for better management oversight and training, better sharing of workloads and increased satisfaction for the staff.

Some firms in high cost locations have taken it a step further and invested in shared support centers in lower cost markets to handle everything from IT support, billing, benefits management, knowledge management, marketing support and in some cases legal services. While the first of these centers was established in 2002 and initial adoption was slow, there are now at least 25 large US-based firms who have moved to this off-site model in locations from Kansas City to Nashville to Manila. Firms have been thoughtful about differentiating between the services required on-site and those that can be equally or more effectively done off-site. A recent ALM Intelligence study indicated that the long-term savings from these centers can be 30+ percent of annual labor and lease costs, although there are significant start-up costs that need to be factored in.

Interestingly, despite some early interest in outsourcing administrative functions to outside providers, relatively few firms have moved in this direction in a significant way. In some cases, the cost of outsourcing is not seen to provide for significant savings and firms prefer to retain control. However, there may be collateral benefits to outsourcing, including not being responsible for hiring and managing outsourced staff, as well as the ability to scale the staff up and down more nimbly than if they were firm employees. Some firms have gone to managed services as an alternative, which means that an outside provider handles management responsibility as well as process and operational functionality of a particular team or function.

## Where are Firms Investing?

While overall ratios of support staff to lawyers may be coming down, the talent mix is clearly shifting. Firms are finding that they need more specialized and more experienced professionals supporting the firm. Key areas of growth include support for pricing and project management, financial analysis, information security and information governance, knowledge management, and sales and business development, among others.

We also see firms increasing their risk management function, with most midsize and large firms now having a General Counsel. In some cases, particularly in larger firms, there is a broader team of 'in-house' lawyers supporting the General Counsel. And more firms are hiring lawyers to handle aspects of the conflict and new business intake processes.

Firms are also rethinking the leadership of the operational side of the firm. In some cases, the COO role has expanded significantly to take on some of the responsibilities typically handled by the Managing Partner, and in other cases the COO role has been eliminated with the next level of chiefs reporting directly to the Managing Partner. Overall, the skills required from the C-suite (CFO, CIO, CMO, etc.) have increased as the scope and complexity of their roles has expanded and sometimes this requires investments in new talent.

Firms are adding new senior level roles in specific areas like strategy, innovation, practice economics, diversity and competitive intelligence. These roles often align with a firm's strategic focus. A firm who has made innovation or diversity and inclusion a core part of their strategy is more likely to invest in talent to support those goals.

When firms experiment with new roles and functions it is important to have reasonably clear expectations for the function. That can be a challenge when a firm is an early adopter – one of the first firms to experiment with a new role or function. However, clarity is critical in order to attract high caliber talent and to win the support of the partners for the investment required.

## What is on the Horizon?

We expect that firms will continue to look for ways to balance the cost of running the firm with the need to make investments in emerging areas. Firms will need to continue to invest in critical areas like information security. Given competitive dynamics, firms will also choose to invest in areas like pricing and business development in order to protect or grow market share.

Space needs are a major consideration for firms and reducing occupancy costs through more efficient use of space and fewer people to house in Class A space is a top priority for many firms.

Overall, firms are focused on cutting administrative staffing expenses, and are requiring lawyers to become more efficient (i.e., self-sufficient) and operational staff to take on more responsibility and broader roles, often spreading resources out across offices, practices, etc. This means that lawyers may need to adapt their approaches and increase their own efficiency. The days of making exceptions for partners may be numbered. Both lawyers and staff need to adapt to succeed.

# HOW TO MAXIMIZE YOUR FIRM'S GREATEST ASSETS? PARTNER PERFORMANCE FEEDBACK

Partners in a law firm represent the firm's most valuable asset. In nearly every law firm, the partners are responsible for generating and managing the firm's clients. They are the face of the firm in the marketplace. And in many firms today, partners are also the most productive group of timekeepers, with higher hours and collections than other categories of lawyers and non-lawyer timekeepers in the firm.

In spite of this, many firms continue to question whether they should invest the time, energy and resources into providing partners with regular, in-person feedback about their performance. Feedback sessions are time consuming and resource intensive, and some firms question the value relative to the investment required. Other firms operate under the premise that law firm partners do not require feedback and should simply know what is expected and how they should be contributing.

We believe that this thinking is flawed and that firms that fail to provide meaningful feedback to partners are missing a valuable opportunity to enhance firm performance.

## Why Provide Partners with Performance Feedback?

People react to the information they are given – or the lack thereof. The absence of direct communication about performance often results in individuals forming their own unguided conclusions about how well they are doing and what is expected of them. This creates the potential for a misunderstanding between the individual and the firm about the firm's view of a partner's contributions, and unfortunately despite some firms' hope that partners should simply know what is expected of them, many partners do not. Feedback sessions provide a forum for the sharing of information about what is working and what isn't working and better clarity in communication between the individual and the firm relating to the full range of a partner's contributions to the firm.

Beyond basic performance expectation setting, feedback sessions are a critical tool in addressing underperformance early on. Every firm struggles with partner performance problems at some level, and formalized annual feedback creates discipline in recognizing and addressing problematic performance before it becomes a long-term drag on the firm's economics. Underperforming partners often lack an objective sense of their own contributions, and, given natural human bias, they also minimize their performance problems when leaders aren't holding them accountable. Feedback sessions force both the firm and the individual to confront those challenges and start to take action to address them.

Often overlooked is the positive impact that performance feedback can have on the highest performers. While it is natural to assume that top performers don't require feedback, positive feedback can be just as critical to maintaining high performance and satisfaction. Many firms also underestimate the value effective feedback can have on raising performance across the broad range of middle performing partners. Raising the performance by 5% of each of the 50% of partners comprising the 2nd and 3rd quartile of performance will have a far greater overall impact than addressing the small minority of badly underperforming partners.

Of even greater value than the review and feedback on past performance, formal partner feedback sessions provide the opportunity to discuss future contributions. These meetings offer an ideal forum for discussing a partner's highest and best use in the coming year and agreeing upon how each partner should focus his or her time in a way which will have the most beneficial impact on the firm overall. This can be particularly constructive in helping mid-performing partners focus on how to expand their practices and reach their full potential. In the most ideal state, partner feedback sessions result in an improved understanding of how a partner can take action to better align his/her contributions with the firm in the coming year.

Finally, feedback sessions create a forum for communication between partners and firm leaders relating to client development and professional development as well. These conversations allow firms to ensure that partners are identifying and taking action to develop work from high priority existing and new clients and are pursuing the professional development opportunities needed to achieve their goals.

## What is the Right Forum and Format for Providing Partner Feedback?

For many firms, feedback on performance is provided to partners as part of the annual partner compensation setting process, in the form of a partner compensation interview or post-compensation feedback session. However, in other firms, particularly in the UK and among firms with lockstep or other compensation structures which are not based on individual partner performance, feedback sessions are structured separate and apart from compensation setting, as annual appraisal meetings.

Whether structured as part of the compensation setting process or outside of it, the best feedback sessions are ones which are led by firm leaders who are familiar with the partner's contributions and performance and who have some level of influence over partner remuneration, to create accountability and align rewards systems. In some instances, this may be a PGL with influence over compensation outcomes. In other instances, this may be a member of the firm's primary governing body and compensation committee who has a familiarity with the partner's practice. There are a variety of approaches that can work but the linkage between leadership role, understanding of the individual's practice and contributions, and compensation influence is essential.

The focus of the session should be both retrospective (review of last year's performance) and prospective (identifying goals and commitments for the coming year). The session should culminate in an agreement between the individual partner and the firm on 3-4 key performance goals for the coming year. These goals should represent high value and actionable efforts, which leverage the partner's individual strengths, and which directly support practice and firm strategy. These goals will also provide the basis for evaluating that partner the following year, creating accountability and follow up on each partner's annual commitments to the firm, and reducing an over-reliance on individually oriented financial metrics.

## What Makes Feedback Sessions Work, or Not?

Unfortunately, providing partner feedback is not an entirely simple affair. It requires significant preparation and strong communication skills. The firm leaders charged with conducting feedback sessions must demonstrate a clear understanding of the partner's performance (based on both financial and non-financial inputs) as well as an ability to communicate with candor and where necessary, tough empathy. Leaders will need to convey knowledge of the partner's contributions and potential contributions and provide messaging which will help motivate an individual partner to reach their potential.

Of course, feedback conversations which are poorly prepared for fail to deliver value and can do more harm than good. Similarly, sessions which don't allow for a two-way dialogue and a clear giving and receiving of feedback are ineffective and can cause firms to question the investment of time, energy and resources. Delivering feedback effectively requires developing leadership skills and aptitude around interpersonal communications, conducting difficult conversations, motivating professionals, and listening, in order to ensure that messages are well-considered and well-delivered.

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Conducting partner performance feedback sessions serves as an invaluable tool for firms to maximize the contributions of their most valuable assets – their partners.  Yes, providing partners with individualized feedback is time and resource intensive. However, it is worth the investment. When firms do not communicate directly with their partners about their performance, they fail to manage them, motivate them, help them, and align their efforts with the firm's overall direction. When firms regularly communicate with partners about their performance and the firm's expectations for their performance, they are better able to maximize and leverage the broader range of contributions that partners are able to make to the firm.

# GETTING MORE FROM MERGERS

Unquestionably there are successful law firm mergers, some hugely so - perhaps most notably the strategically sound international ones that have created the grouping of highly profitable leading global firms that are increasingly winning a larger share of the highest value work. At the opposite end of the spectrum are the many smaller mergers, often significantly defensive, which while not transformational to the industry have provided the scale to allow the firms involved to maintain their market position and continue to compete effectively in a consolidating market; we cannot know for sure what would have occurred without merger but for many as smaller independent entities they would likely have been squeezed into unfavorable positions.

In spite of these success stories, there are still mergers that provide less value. Research over the past few years by both leading business schools and the Big 4 Accountants has concluded that the significant majority of corporate mergers and acquisitions do not deliver the anticipated revenue or cost benefits and indeed often dilute rather than create value. While these studies do not cover law firm mergers, we know that a number of law firm mergers have similarly failed to achieve the anticipated strategic benefits, such as better market positioning, winning larger or more complex projects, and delivering substantially higher profits.

A key reason we believe that many law firm mergers are delivering less value than they should is because insufficient focus is given to a key determinant of success – revenue growth.

The foundation of a successful merger is a strong business case that is relevant to, and centered on, clients. Success in merger is highly dependent on client expansion and income growth. Unfortunately, some merger discussions fail to produce meaningful analyses or forecasts of potential revenue growth that will result from the combination. In fact, some firms even default to focusing on potential cost savings rather than potential revenue growth opportunities. To a certain extent this is understandable. Potential cost savings are more tangible, and forecasts can be built by reviewing the income statements and budgets of the two firms. But given that law firms are high margin businesses, cost savings will deliver far less impact than revenue growth over the long term.

Identifying revenue growth opportunities is more difficult and generally much less certain. It isn't, however, impossible. And particularly importantly, a focus on this can help identify the key actions the merged firm needs to take once it is launched. Income growth can come from existing clients - providing a greater volume of services to them (and possibly at better margins) - and/or by attracting new clients. Opportunities to provide a greater volume and range of services to existing clients can be evaluated in a variety of ways, including assessing key clients of the two firms, evaluating the relative strengths of the combined firm compared to other firms working for each key client, considering lost opportunities with existing clients, assessing recent declines in work, etc. Focused mergers which create revenue growth utilize these types of assessments to build forecasts of the revenue growth and client expansion opportunities likely to result from merger.

Less commonly undertaken but generally the best source of valuable information are interviews with clients of each firm. They can be powerful in not only exploring clients' opinions of the proposed merger but also help identify the potential (and steps necessary to realize this) to attract a greater volume of work in the future. This is absolute gold-dust in terms of input to planning and executing the merged firm's integration and business plan. Clearly the timing of such research needs to be carefully considered - in particular if there are confidentiality issues. Our experience, however, is that clients are happy to be involved in such discussions, are pleased that their views are being sought and will respect confidentiality.

The potential for attracting new clients tends to be a largely internally focused exercise. It is often undertaken at a practice or industry group level and can be based around exploring the two firms' existing 'target client' lists. It provides further opportunities for partners in the same practice groups of each of the firms to work together to identify how in combination they might be able to attract specific clients and work and how the greater strength and capability of a combined firm might succeed.

Wider opportunities, created for example by one firm having a particular service capability that the other firm doesn't can also be explored. The assessment can also focus on lost opportunities – lost pitches for example, or circumstances when perhaps neither firm was even invited to pitch. An honest assessment of whether the outcome might have been different had the two firms been combined can be a useful data point.

These discussions, providing they are well planned and managed, also have wider benefits beyond the immediate task at hand in terms of allowing partners to get to know their future partners and understanding each other's respective skills, expertise and way of working. This exposure helps in the combined firm integration efforts and helps to bring revenue opportunities to the firm more quickly.

Of course, activities such as these will not come up with precise forecasts of revenue growth. That, however, really isn't the point. If they fail to identify meaningful revenue growth opportunities, we would argue that they highlight the need for there to be some extremely powerful alternative rationale for the proposed merger. And if they identify more promising income growth opportunities they can be a critical input to the setting of objectives and planning for the future success of the merged firm. Without such analyses firms can believe that there are income growth opportunities without evidence to support it and can miss opportunities that do exist by being unaware of them and hence not focusing efforts accordingly.

We are certainly not advocating for any lesser focus on identifying the potential for cost savings in a merger. What we are arguing is that far greater focus should be placed on identifying the revenue growth opportunities because it is here that the potential for success of most law firm mergers lies.

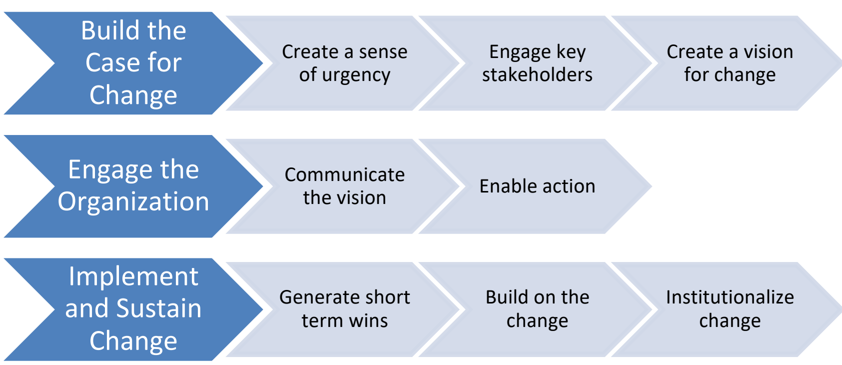
# ENCOURAGING CHANGE

Despite the relentless news about the changes affecting the legal industry we still hear law firm partners question why they need to change anything when the current model is working for them. There is of course some truth to this. While we have seen external forces impact the industry, from changes in the way clients view the value of their outside lawyers, to the growth in non-traditional competitors (e.g., virtual firms, outsourcers, Big 4 accounting firms), to the potential for technology and artificial intelligence to replace some of what lawyers do, all of these forces have mostly nipped at the edges of traditional law firms. Further, while the economics of law firms have surely been tested in recent years as growth in revenue and profits have slowed, the legal industry as a whole remains a very profitable endeavor for law firm partners.

While the legal industry hasn't (yet) experienced a major disruptive event that it hasn't recovered from with its model largely intact, all the forces we see today are what we refer to as being 'pecked to death by ducks.' The cumulative effect of these forces is already impacting traditional firms and that impact will continue to grow.

Further, based on research testing personality traits of lawyers it is clear that as a group lawyers tend to be skeptical and risk averse. While these are valuable skills in a legal context, they can also result in a resistance to change. It's not surprising that partners question the need to change. However, ultimately law firms will be forced to change despite the best efforts of many partners.

So how can leaders break through change resistance and better position the firm for the future? There are some useful lessons to be learned from traditional change management approaches. John Kotter, in his classic book Leading Change, outlined an eight-step approach to change management. These eight steps can be loosely organized into three broad categories:




Some of these steps are intuitive, but others are not. While there is often a temptation to skip one or more steps, each is important. While the scale of each will vary with the size of the project, going about even small changes in a deliberate way will help ensure success and pave the way for future change.

Once a project is identified, key steps include:

- ***Educate the firm on "why change" is needed***. What are the forces demanding change? What happens if the firm doesn't change? What are the benefits of change? The case for change is strengthened if you can include data and analysis rather than vague concepts or change for change's sake. The voice of the client can be a critical component here in convincing partners of the need for change, whether through client interview feedback or client panels at retreats or other forums. The "why change" needs to support the specific project, not just the idea of change in general.

- ***Get key stakeholders on board.*** There are two groups you will want to focus on - first is the group who came up with a new idea or who will be leading the initiative. Typically, this group should include at least one partner. While it is tempting to delegate to associates and staff, the reality in many firms is that it may be harder for that group to get the buy-in required than a partner led group. The second group is the potential naysayers, particularly those who are regarded as leaders in the firm. This group may require one-on-one attention to bring them along and to make sure they don't hold back the initiative.

- ***Articulate the vision for the specific project.*** It's important to not only be able to tell lawyers what the project is about, but how it will be executed and what the expected benefits are. It is important to anticipate questions that partners may raise (possibly by testing the concept with skeptical partners in advance).

- ***Communicate the vision.*** Use multiple platforms for communication. A single announcement at a partner meeting or via memo is unlikely to resonate with many partners. Take advantage of one on one conversations, written communication, partner meetings, using ambassadors (your key stakeholders for example) and the like. Reinforce the message throughout the process.

- ***Enable action.*** In the law firm context enabling action includes not only providing resources but removing barriers. A pricing initiative, for example, may require software support and resources from the finance team but also requires attention to partner performance metrics to ensure that partner incentives don't discourage experimenting with new pricing approaches.

- ***Generate short term wins and build on them.*** Look for ways to pilot small projects to generate early successes and results. Communicate these successes broadly and build on them. At the same time, it is important to be realistic about the impact of new initiatives. The return is more likely to come over the long term with the cumulative impact of multiple changes, so building on early wins is critical to generating ongoing support.

- ***Institutionalize change.*** Over time it is important to make the change a regular part of the firm's operations. The initial team may no longer need to be shepherding the project. The firm will need to evaluate what is required for the project to become a normal business practice.

Just as the changes impacting the legal market are coming in small bites, change in the firm can be taken in small steps. While big projects have the potential to flounder, small successful projects can give the lawyers, and management, confidence. The small projects can expand to bigger projects and can also encourage new ideas.

The profitability of the legal industry is one of the things that makes it attractive to new entrants and a target for disruption. And the reluctance of firms to change creates an opening for some of those new entrants to reinvent the model. Firms who do not examine at least some aspects of their business model are at risk of falling behind over time. Managing change effectively can help create an openness to change that will serve the firm well over the long term.

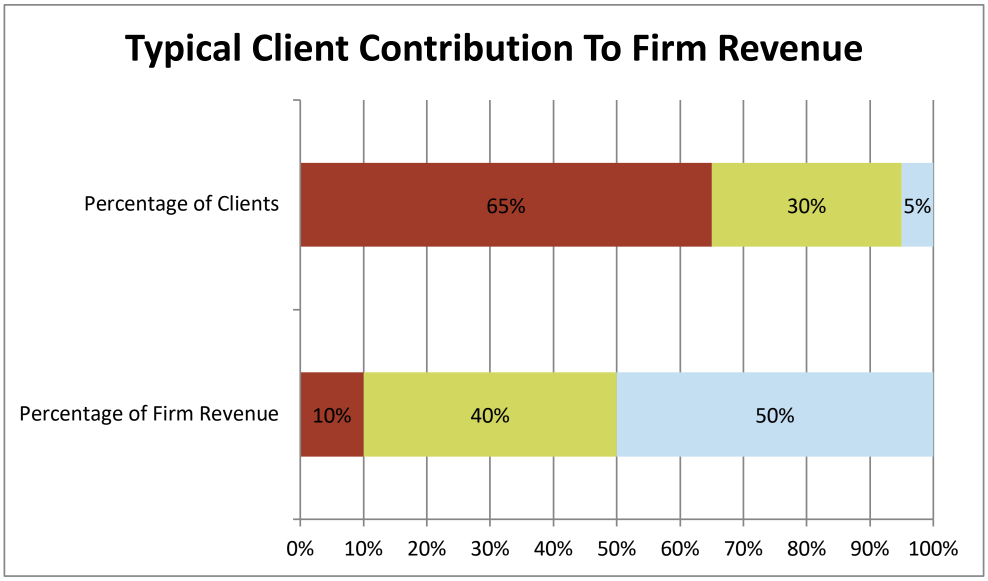
# IMPROVING PROFITABILITY FROM CLIENT AND MATTER ANALYSIS

Almost uniformly law firms highlight the most demanding and complex (and high fee generating) work they undertake. This is designed to position firms as they wish to be perceived and reassure potential clients about their capabilities.

Many firms do indeed undertake at least some highly complex, demanding (and sometimes newsworthy) work which generates high fees and of which quite rightly they are particularly proud. Unfortunately, this can be over-emphasized, contributing to a belief within the firm that a high proportion of its work is or should be of this nature. This in turn leads firms to operate business models which align with that kind of work - with, for example, a strong focus on partners undertaking work, low leverage, and a limited focus on work process efficiency, knowledge capture, and the like. The assumption is that the firm is largely undertaking one-off, complex matters where high levels of partner input are essential and process streamlining is not a priority as the work undertaken is of a nature that is not suited to delegation nor is it regularly repeated.

The reality in many, many firms however is that such matters are an extremely small proportion of the work they undertake. In fact, the majority of work undertaken is just the opposite - of relatively low monetary value in terms of fees per matter (and often per client too) and repeatedly undertaken.

Typically, our analyses show that around two-thirds of a firm's clients generate as little as 10% of its total revenue and an even smaller percentage of profit, while just 5% of its clients are contributing around a half of the firm's revenue. And this split tends to be even more marked at the matter level.



Interestingly we find this across all types of firms: in small and medium-sized ones largely acting at a local or regional level, in niche practices acting at a national level and through to large international firms acting in multiple jurisdictions and with many offices. Of course, there are exceptions, but in firm after firm we find that the significant majority of work undertaken is relatively low value in terms of fees per matter and in aggregate it contributes relatively little to total revenue.

Such analyses are very straight-forward to undertake – as a first step it simply involves ordering the clients (or matters) by fees generated from smallest to highest and then calculating the total revenue by each decile. Further analyses can then be undertaken depending on what this initial assessment shows.

The large number of individually low fee generating matters tend to contribute even less to profitability - this is for a variety of reasons, but a few are particularly common:

- First, the firm's business model, as noted, tends to support the complex, larger scale work rather than the predominant, lower fee generating matters and there is insufficient leverage or investment in technology that would better suit such work; quite simply there is a misalignment between the 'cost of production' and the fees generated.

- Second, except if firms have appropriate processes and procedures in place it is difficult for timekeepers to achieve high productivity when working on multiple small matters, further complicated by write-offs or under reporting of time as a result of price sensitivity.

- Third, there are the costs of opening files, compliance, billing, etc. which are largely fixed and hence which impact on the profitability of smaller matters and clients to a greater extent than on larger ones. Further, there can be hidden costs to the firm of conflicting the firm out of larger matters/clients.

Firms that find that they do have a large proportion of individually low fee generating (and often only marginally profitable) matters should not jump to conclusions about jettisoning such work. Indeed, there are notable firms that are highly successful and profitable who specialize in such work. And many firms are simply not in a position to turn away such matters, particularly for clients who may turn to the firm for a range of work.

For firms that conclude that they wish or have to undertake such work the core issue becomes one of making it as profitable as possible. Our experience is that the profitability of such work can often be improved, and sometimes dramatically, with well designed and implemented process improvement; this may need to be fairly radical in terms of changing the level (and hence cost base) of the staff undertaking such work, moving it to lower cost locations, significant investment in IT, and so on.

For firms that decide that they wish to reduce the amount of such work undertaken there are a host of strategic, operational and financial challenges and we have worked with firms who have implemented a variety of plans including separating a segment of such work into a separate business or spinning off that work to another firm.

Where we believe real danger lies is in firms not recognizing and reacting to the reality of the work they undertake. Such firms will continue to dedicate significant resources to undertaking a relatively large volume of work which in aggregate generates limited fees, they will continue to make a marginal (at best) margin on it and find over time it has a highly detrimental strategic and financial impact on the firm overall.

# 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?

## Calculated Lateral Growth

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 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.

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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 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.

# A LOOK BACK,
# A LOOK AHEAD …

As we began 2018 it was a good time to reflect on the past year and anticipate the coming year. Here are just a few of our observations on the legal industry in 2017 and predictions for key themes in 2018 which warrant preparation and action.

## A Look Back at 2017

Overall, 2017 was a relatively stable year for the legal industry, with continued market forces impacting law firms, but few revolutionary events. We anticipate that year-end financial reporting will reveal that average law firm financial performance showed modest gains in 2017. Throughout 2017 demand for legal services from large law firms continued to be challenged, with fee pressure from clients, increasing competition from new service providers, the efficiencies that come from better application of technology, and a slowdown in M&A activity.

While firms continued to manage expenses aggressively, 2017 expenses included the full year impact of 2016's associate salary increases without a proportional increase in revenue, moderating profit growth. And as has been true for the last several years we find that the average performance of the industry does not tell the whole story as performance is far more variable than in the past. Some firms will see double-digit growth in profits, while others may see double-digit declines. Firms with year-over-year declines in profitability are vulnerable to partner losses and instability.

We also saw continued consolidation in the legal industry in 2017. Law firm mergers in the US were at their highest level since 2001, with 65 mergers completed in 2017. Much of the uptick in mergers was attributable to a high level of cross border mergers, with 19 such mergers in 2017. Law firms have continued to look to geographic and practice expansion as a way to remain competitive. Lateral partner activity remains high as well, although the low success rate for laterals remains a challenge for many firms. In fact, we've seen some firms invest in laterals but with subsequent departures of some of those laterals, along with other turnover at the firm, end up without any material gains in lawyers and profit.

Finally, mirroring the trends in society more broadly, 2017 brought the acceleration of a focus on gender issues in law firms, reflecting renewed concern over the number of women partners, gender pay gaps, discrimination and harassment. Firms are just starting to address the impact of these issues and more are likely to emerge in the coming year.

## A Look Ahead to 2018

While 2017 did not present revolutionary change for most law firms, 2018 will see renewed competitive pressures and market turbulence.  Maintaining market share and financial performance in 2018 will require both solid management of the fundamentals, as well as action in implementing key strategic changes.

***Managing fundamentals.*** Firms must continue to pay attention to the fundamentals in 2018 – a clear and differentiated strategy, a focus on clients and strong financial management. The current competitive environment and relatively flat demand in the legal market leaves little room for firms not minding the basic elements of success - aggressively developing clients and business, eliminating excess capacity, maintaining efficient operations and addressing succession and retirement of senior lawyers. In addition, firms must also manage against and respond quickly to unanticipated internal challenges – loss of a major client, lawyer defections, office shrinkage, etc. Recent dissolutions of once successful firms reflect the need for firms to remain vigilant in avoiding client and lawyer losses, and if necessary, taking quick action to close offices or cut staff if required.

***Diversity in firm leadership.*** In addition to continuing to focus on increasing gender and racial diversity among lawyers and staff, firms now also need to place a greater emphasis on developing women and diverse firm members into top leadership roles. It is no longer enough to simply hire women and diverse lawyers and staff - they must be given opportunities to succeed and in a workplace that is free from harassment. The vast majority of law firms continue to struggle with underrepresentation of women and minorities in the top management of firms. We believe that 2018 is the year that firms must and will address this shortcoming.

***Strategic growth.*** Much of the uptick in mergers last year and in earlier years was driven by a recognition that many firms must continue to build depth and breadth in core practices and markets in order to compete. Of course, not every firm needs to grow at a fast rate, but for those who believe it is an effective way to implement their strategy, merger will continue to be an attractive option in 2018. A key success factor in identifying and executing truly accretive mergers will be an ongoing focus on strategic priorities and avoiding investments of time and energy in growth which does not offer an opportunity to materially improve the firm's market position. For firms pursuing growth via laterals, the low success rate for laterals will remain a challenge. Firms will need to adopt a strategic approach to both hiring and integration to reduce the otherwise inevitable and expensive churn and be prepared to take quick action when laterals do not follow through in providing the contributions and value promised at hiring.

***Embracing change.*** While we have seen external forces impact the legal industry, from changes in the way clients view the value of their outside lawyers, to the growth in non-traditional competitors (e.g., virtual firms, outsourcers, Big 4 accounting firms), to the potential for technology and artificial intelligence to replace some of what lawyers do, all of these forces have mostly nipped at the edges of traditional law firms. Further, while the economics of law firms have surely been tested in recent years as growth in revenue and profits have slowed, the legal industry as a whole remains a very profitable endeavor for law firm partners. The profitability of the legal industry is one of the things that makes it attractive to new entrants and a target for disruption. And the reluctance of firms to change creates an opening for some of those new entrants to reinvent the model. Firms who do not examine their business model are at risk of falling behind over time. Successful firms in 2018 will encourage their lawyers to be innovative, to be flexible and to embrace rather than resist change.

***Risk management.*** Most firms have robust conflict and client acceptance processes in place. But risk management in law firms today goes far beyond conflict clearance. Firms need to have proactive plans in place to reduce malpractice claims. They need to reduce or eliminate the potential for rogue partners whose behavior can reflect badly on the firm (and create financial risk). They need to protect against lawyers and staff misusing firm or client funds. And perhaps most significantly, firms need to have robust cybersecurity protocols in place to protect client data and to ensure business continuity. Trust and informality are not an effective approach to risk management in 2018.

2018 begins with optimism. Firms who focus on the fundamentals, have a clear and executable strategy, and address these emerging issues of importance, should be well positioned to succeed.

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## Strategy and Management Consultants to Law Firms

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Our consultants have advised firms in the US, UK, Continental Europe, the Middle East, Africa and Asia. Our clients include the largest international and national firms and leading firms of all sizes.

Our focus on professional services, and law firms in particular, is built on a deep understanding of and experience with the strategy, organization and motivation of partnerships.

We believe that effective decision-making and execution requires objective, clearly communicated analysis. Our analytical strength, combined with our deep experience in the industry, provides our clients with a competitive advantage.

We build long-term advisory relationships with our clients. This depth of knowledge allows us to serve as trusted advisors, advising efficiently and specifically.

COMPENSATION FOR LEADERSHIP

THE EVOLUTION OF PARTNER PEER REVIEW

THE CRITICAL LINK BETWEEN MANAGING PEERS AND MANAGING CHANGE IN LAW FIRMS

INCENTIVIZING AND COMPENSATING PARTNERS IN TRANSITION TO RETIREMENT

TIME TO RETHINK YOUR STAFFING STRUCTURE?

HOW TO MAXIMIZE YOUR FIRM'S GREATEST ASSETS? PARTNER PERFORMANCE FEEDBACK

GETTING MORE FROM MERGERS

ENCOURAGING CHANGE

IMPROVING PROFITABILITY FROM CLIENT AND MATTER ANALYSIS

CALCULATED LATERAL GROWTH: BALANCING THE RISK-REWARD RATIO

A LOOK BACK, A LOOK AHEAD …