Understanding The Lateral Hiring Frenzy

Richard T. Rapp, Principal, Veltro Advisors, Inc.

Why is lateral hiring proceeding at a frenetic pace even though legal employment is far below its 2007 peak? According to *The American Lawyer*, "Among Am Law 200 firms, the lateral partner market was so overheated that 92.5 percent of respondent to [their] new partner survey released in November said that legal recruiters already had approached them."[1] Is lateral hiring at this pace a destabilizing force in the law industry or a sensible, productive feature of the legal labor market? And is it transitory or will it last? To know the answers requires stepping back to understand the economics of the market for lawyers. We can address this in two parts: first, managerial motives for lateral hiring which are easy to understand and, second—and harder to grasp—the market forces that propel lateral mobility, the likes of which we do not find in most other markets for senior talent.

As it turns out, the best way to think about lateral hiring among law firms is as a kind of arbitrage; arbitrage that is likely to persist as long as the gains to partners from shifting are available. When we think about arbitrage we usually think about buying and selling to capture the gains from differences across markets, for example, differences in Euro-Dollar exchange rates between London and Singapore. But more generally, arbitrage refers to any effort to gain by exploiting differences in prices. In this case it is differences among law firms in the price of legal talent that is the main—though not the only—motivator of lateral moves by senior lawyers.

Managerial Motives

Law firm managements engage in lateral hiring to achieve growth, diversification, and enhanced sharing of overheads. These benefits for law firms are easy to understand.

Growth, if profitable, increases the aggregate profit of the firm, although this does not necessarily improve the incomes of incumbent partners. To the extent that the financial viability of the firm as a whole is strengthened by profitable lateral hiring,

[1] "Perpetual Motion: The Hiring Frenzy at Large Law Firms Continued in Full Force Last Year," *The American Lawyer,* February 2016, p39.

then incumbent partners are better off as a result. It may take a while to realize these gains as lateral hiring of successful senior legal talent typically requires overpayment. That is to say, the hiring firm must pay its normal compensation for senior talent plus a premium to encourage the lateral to overcome inertia and assume the risks of moving to the new firm. This implies a reduced margin of profit in the short run. One must be careful not to overgeneralize—there are expected added payoffs that can outweigh the lateral partner's high initial price. These include building new (or building up weak) geographies or practices; diversifying the firm's exposure to practice-specific business trends and reducing the per-partner burden of overhead costs. These managerial motives all make good business sense but there is a complicating factor. Not all lateral hiring yields long-term profitable attachment to the hiring firm. The risk of underperformance or outright failure is the principle downside of any lateral acquisition.

Some would argue that the lateral hiring frenzy is an aberrant, mistaken and expensive quest for rapid growth. But the proposition that managing partners are delusional and self-destructive cannot really explain why lateral hiring is so prevalent in the law industry compared, for example, with other professions or high-income occupations. If the success over time of one lateral hire exceeds in profitability the loss from several others that didn't work out, then survey-response headcounts of lateral wins and losses are worthless. To understand lateral hiring we need to dig deeper.

The Underlying Economics of Lateral Mobility

Here, in reverse order of importance, are the economic forces that determine the nature and pace of law partner lateral hiring:

5. Low firm-specific investment in human capital

4. Leverage, or the ability of successful partners to employs other lawyers, enabling large-scale individual practices

3. The shared fate of partners in a law firm and vicious and virtuous circles

2. Variable and often limited value of firms' brands relative to the reputations of successful individual partners

1. Diversity of partner pay programs

5. Low firm-specific investment in human capital

The success of a law partner depends upon many things but deep knowledge about the firm he or she works in or joins is not one of them. What can be learned about the workings of a particular firm can be learned quickly and without much cost. The need to acquire costly firm-specific knowledge might present problems for recruits in settings where intimate knowledge of a firm's networks of technologies or people is needed. There is no such impediment to changing law firms.

4. Leverage, or the ability of successful partners to employ other lawyers enabling large-scale individual practices

Leverage is what makes lateral hiring worthwhile. Successful rainmakers employ other lawyers within their firms for large or numerous cases and the scope of this leverage multiplies the profit contribution of the rainmaker. When we look at the market for physicians or university professors we see competition among institutions but without the same intensity as we observe in the market for law partners. That is mainly because doctors and teachers are not big employers in within their institutions and are not thought of as contributors to institutional profitability to the same degree as rainmaker law partners. There are exceptions, of course. Universities are reputation-maximizers, so the competition for those professors at the very top of their fields can be intense. Scientists who win big research grants do employ teams and it is safe to suppose that they are recruited in a manner resembling law partner recruitment.

3. The shared fate of partners in a law firm and vicious and virtuous circles

Although individual partners' practices are often portable from firm to firm, there is no doubt that when the fortunes of a law firm decline, every partner is affected. The sense of shared fate in firms with strongly cohesive cultures can mitigate against the centrifugal force arising from a streak of bad results. But when partners leave while other firms are doing well, those who are capable of being recruited will naturally wonder how much better off they would be somewhere else. Fear of being the last partner left to turn out the lights can induce a vicious circle of departures and failing fortunes for the firm. We all remember the names: Shea & Gould, Brobeck Phleger, Heller Ehrman, Howrey & Simon, Dickstein Shapiro and many others. In hard times for the profession as a whole especially, the pace

lateral hiring is quickened by partners leaving firms in decline. By the same token, a successful firm that earns a reputation as a good haven for laterals benefits from the virtuous circle of talent gains and profit gains.

2. Variable and often limited value of firms' brands relative to the reputations of successful individual partners

Like everything else about the law profession, the value of law firm brand and reputation are not subject to generalization. We all know the firms whose names are synonymous with success and power. We also know firms whose brands, despite a fine reputation, do not much enhance the prospects of their partners. And we all know clients who say, "I hire the lawyer, not the firm." Many successful partners can change firms without losing business; that is the condition of the law profession that enables partner mobility. It's less easy to move in, say, the audit and management consulting occupations. People do leave the Deloittes, PWCs, McKinseys, Accentures and the like, but unless they move to one of the small number of equivalent firms their personal practices will shrink because the reputations of these firms typically loom larger for clients than the reputations of individual partners. Loyalty of clients to individual law partners and the clients' willingness to change firms to stay with those favored partners enables lateral mobility.

1. Diversity of partner pay programs

As I have described elsewhere at length,[2] the most remarkable thing about law firm partner pay programs is their extreme diversity and idiosyncratic nature. The range runs from lock-step by generation to "eat what you kill." Some pay arrangements are totally transparent; others totally opaque. Some inculcate a strong sense of shared fate with firm-wide profit growth the main engine of individual pay growth; others are highly individualistic. And so on. To the best of my knowledge this diversity of pay criteria and administrative arrangements is very hard to find elsewhere in the U.S. economy:

[2] "A Small Treatise on Law Firm Partner Pay Programs," available upon request from www.veltroadvisors.com .

> Most people receive their pay in one of a very few ways –hourly wage, piece rate, salary + bonus and perhaps a few variations on each. In the upper strata of executive pay, we also find uniformity. Most corporate pay plans for senior executives closely resemble one another (salary + cash bonus + restricted stock + stock options tied to a relatively few business unit- and firm-level reward criteria). Hedge fund managers' performance fees are usually the simple "two and twenty" formula, sometimes with a "hurdle" to reward excess returns over a market benchmark. Thus, for most occupations from the lowest to the highest earning ones, it isn't hard to know how your pay is going to be decided.[3]

The consequence of the diversity of partner pay programs is that there is no such thing as a market-wide wage for legal talent, even when the revenue and profit potential of a partner is perfectly well-known. Each law firm with its own often-opaque private pay arrangements is distinct and because firm cultures differ one from the other as well, pay plan differences persist. No single plan type dominates others in encouraging productivity and improving the odds of survival. For the individual, partner with lateral mobility, movement involves finding the best fit between the partner's pay goals and collegial preferences and the culture and pay programs of firms. From the standpoint of the market for senior legal talent as a whole, lateral hiring is arbitrage--reducing imbalances between the pay and perquisites of partnership offered by different firms. Although arbitrage tends to reduce the differences among firms, differences will persist so long as firms continue to succeed under a wide variety of different pay regimes.

Large difference in law firm profitability also create a potential for lateral mobility. A highly profitable firm can attract a new hire from a lower-profit firm, increasing her income substantially without diluting the pay of incumbent partners.

Lawyers with portable practices can and will move to better their pay.

---

[3] "A Small Treatise," p. 4.

A Prediction and an Inference

With an understanding of the economics of lateral hiring we can make a prediction: the lateral hiring "frenzy" will be long-lived. It will persist so long as the wide variety of differences in partner pay programs persist. There is no reason to think that those differences are going to evaporate any time soon.

The inference: Lateral hiring is a fundamentally constructive influence on the law profession. It has the effect of aligning the preferences of mobile partners with those firms that accept them and bringing legal talent into its "highest and best use."

Obviously, differences among law firms in compensation are not the only cause of lateral motion by partners. A desire to escape from internal competition or personality clashes, a wish to be with fellow specialists or a wish to be a lone specialist and many other non-wage motivations induce senior lawyers to change firms at times. But in order to gauge the dominant reason why partners change firms, perform this thought-experiment: Imagine the law business as we find it today with one exception. Suppose there were a prevailing, uniform formula or pay scale based upon revenue or profit contribution so that all firms would pay any lawyer neither more nor less than N % of his or her practice size, with whatever predictable complications you care to imagine. In this hypothetical world of one market wage for practice size (or profit contribution) you can be certain that lateral mobility would be a small fraction of what it is today. In this world, recruiting discussions would be without talk of money. The uniformity assumption eliminates the pay-betterment or arbitrage motivation for changing firms. QED.