The Financial and Political Risks of Lateral Partner Hiring

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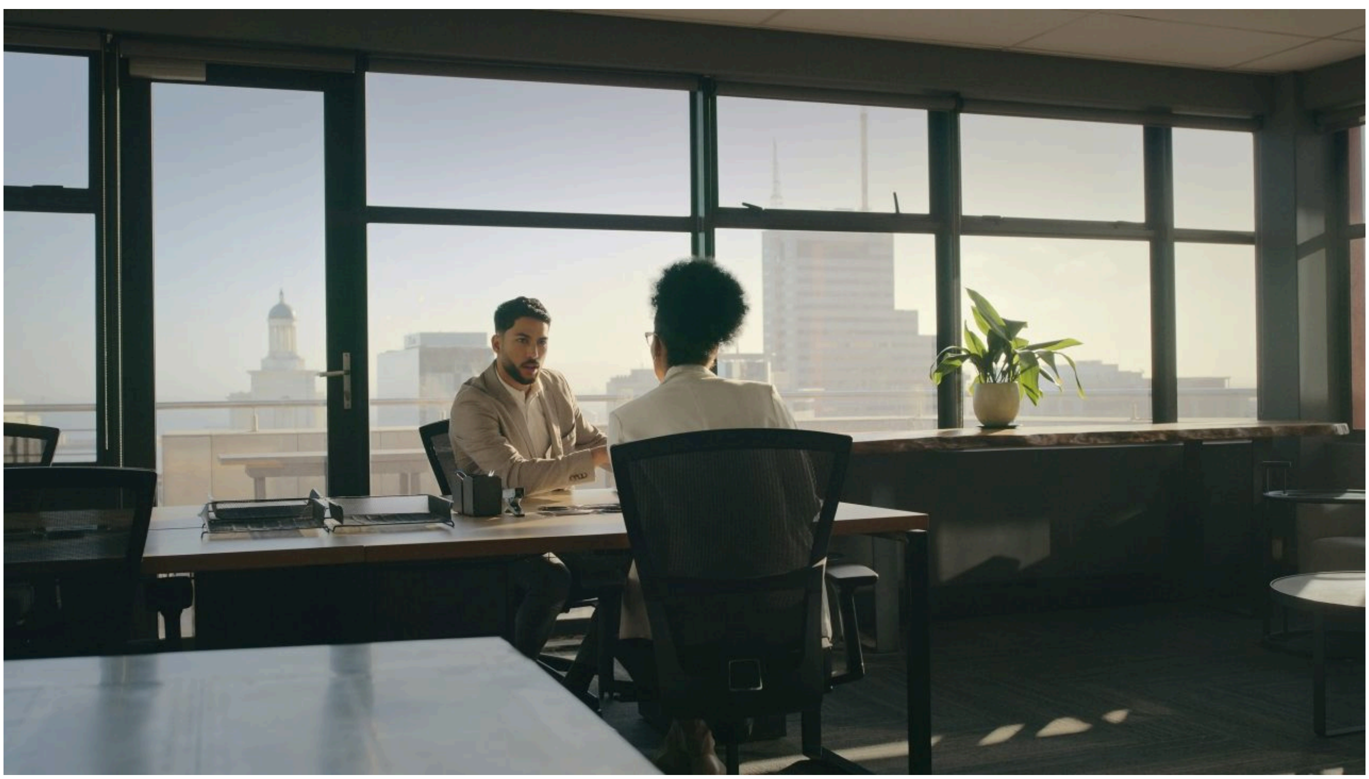
Summary

- Lateral equity partner hires are risky but potentially high reward.
- Financial and cultural missteps drive high failure rates.
- Firms must vet rigorously and integrate hires carefully.
- Success improves when hires align with strategy and storytelling.



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Before large law firms make important lateral hires, they first must hold their breath.

Making a lateral hire is uncertain business, carrying risks that are considerable if not daunting. The rewards of a successful lateral hiring strategy, however, are substantial enough to make the effort of analyzing and accounting for those risks worthwhile. This article will describe the major financial and "political" challenges associated with lateral recruiting and conclude with points on what law firms can do to mitigate them.

A Big, Risky Decision

Let's begin, however, by establishing a point that is increasingly obvious: in the year 2025, making an equity partner at a law firm of any considerable size is a serious business decision. Last year, firms in the Am Law 100 generated average revenue of $1.4 billion and average profits per equity partner of $2.4 million. Even a small ownership slice of such a large pie is highly valuable, and not something that any business owner would or should grant too freely.

Law firms, understandably, want to ensure that in exchange for diverting a stream of profits from their (often billion-dollar) businesses, they get more than enough rain to make up for it. In recent years, we have seen firms adopt any number of measures that increase the barriers to equity partnership. The length of time required to reach equity partner status has lengthened; it is now commonly 10 to 12 years, and sometimes longer at top Am Law 100 firms. Of course, time on the job alone is not enough to make equity partner. Exactly what the other criteria are, though, is becoming a murkier issue at many firms. Relevant factors often include origination credits, cross-selling ability, internal firm influence and a willingness to buy in for capital amounts that can exceed $1 million. Overall, these factors are becoming less transparent.

Related to the extended timeline, many firms have also shifted to a two-tier partnership model, in which the non-equity tier acts as a way station where those lucky enough to proceed to equity status can wait five years or more for equity consideration. For others, the non-equity tier becomes a final destination. Currently, fewer than a quarter of partner promotions at many large firms are being made to equity positions. By 2023, equity partners represented only 55 percent of all the partners at Am Law 100 firms, and that percentage is going down.

These increasing barriers make it a lengthier and more difficult process for associates to achieve equity partnership. From the law firm's perspective, however, the barriers have the theoretical countervailing benefit of de-risking the decision to promote an associate or non-equity partner to the equity partner ranks. By the time promotions happen, the firm has intimate knowledge of the lawyers' abilities, it has deep information about the lawyers' relationships with their clients and it has observed the lawyers' place in the social fabric of the law firm for years, if not a decade.

If that were the case for all equity partner decisions, it would be risky enough. However, a substantial—and growing—share of equity partners is being made through lateral hiring.

For homegrown talent, this further narrows the path to equity partnership. For the law firm, meanwhile, it makes the decision to create a new equity partner even more risky, as firms simply cannot have as much information about a lateral hire as a longtime member of their team.

Just as firms have raised barriers to internal candidates, they have also heightened their requirements for lateral equity partners. Some now require lateral partner candidates to have $12 million books of business before they talk to them. One might reasonably think that partners who have proven successful enough to create eight-figure books of business are a safe bet, but that's not the case. Multiple studies indicate that 50 to 60 percent of lateral hires underperform or leave their firm within five years. It's an astounding failure rate, but one that persists due to the significant financial and political challenges of bringing in an equity partner from the outside.

Financial Challenges

The major financial risk associated with a lateral equity partner hire can be stated simply —that is, the risk that the revenue generated by the lateral partner will not exceed the cost.

That risk is as big as it is straightforward. The approach that many large law firms have taken to lateral hiring can be likened to the approach that movie studios have taken to production. Both want surefire hits, but in the name of creating surefire hits, they have increased the downside risk of their assets. In the name of ensuring a good opening weekend, movie studios acquire expensive IP, hire expensive actors, and undertake expensive marketing campaigns—raising the chances of success, yes, but also raising the financial stakes of each individual production.

Likewise, law firms have sought to ensure the success of their lateral hires by considering only those with large books of business. But of course, talent like that doesn't come cheap. To attract a lawyer with such a successful practice, a law firm must reach deep into its pockets. It will have to offer handsome compensation, which is increasingly likely to involve a guaranteed draw for the lateral candidate, at least for some number of years. And every dollar of that guaranteed draw increases the risk to the firm if the hire does not succeed.

Of course, firms incur substantial additional costs in lateral hiring. There is the cost to recruit, onboard and integrate a lateral partner, which can easily exceed $1 million. And there are many other less easily identified costs, including the opportunity cost of not putting the resources that went into the lateral recruiting effort into, for instance, the development of existing associate talent.

None of that spending keeps the hire from posing a financial risk. Industry data suggests that only 70 percent of a lateral hire's stated book of business actually follows them to their new firm. Some exaggeration in a lawyer's portable billables might be expected, but a 30 percent difference between promises and reality is significant. Perhaps even more troubling for hiring firms is the fact that if you look only at the business that travels over with the lateral hire, it is routine for a drop-off to occur in the 18 months following the move, due to lingering client loyalty to the former firm or relationship disruption.

Political Challenges

All this is troubling enough before you even get to "political" risk associated with a lateral hire. That term is fraught with meaning today. Since January, we have watched firms and individual lawyers wrestle with a category of political risk that they have never encountered. But even in the narrower sense of office politics, there are many ways that a lateral equity hire can go wrong.

In some ways, the risk of failure for political reasons is more within the control of the hiring firm than the above financial risks discussed. In rare cases, for instance, a lateral hire will not work out due to client conflicts that could and should have been discovered and addressed before the hire was ever made. More commonly, firms fail to make the effort needed to successfully integrate lateral hires into their culture. Firms that lack a lateral integration process see 30 to 40 percent higher rates of attrition among their lateral hires than those with such programs. More difficult to turn up—but not impossible—are problematic traits of a lateral hire, including poor treatment of colleagues or substance abuse, which impede their performance and make them undesirable additions.

Perhaps unsurprisingly, the biggest political issue is also a financial one. The large pay packages needed to entice lateral hires do not just add financial risk; they can also create tension within a firm. Unhappiness among existing partners with the compensation given to lateral hires is the second-most-cited reason for internal partner dissatisfaction, according to McKinsey Legal Research.

How to Minimize Risk in Lateral Hiring

How can firms address the considerable financial and political risks they face? The answer will vary based on each firm's unique circumstances, but we can draw at least three broad conclusions. First, the answer is probably not to avoid lateral hiring altogether. There's a reason that firms continue to do it despite the relatively high failure rate. Even when pursued with modest degrees of success, it's one proven step among many that firms can take in seeking growth.

Second, firms can and should devote more resources to the vetting of lateral hiring candidates. No good deal lawyer would ever counsel a client to not perform comprehensive diligence on a major acquisition target, yet firms fail to do so every day in lateral hiring. Performed correctly, the vetting process can uncover information that currently goes unearthed in many lateral searches. By speaking to market peers and others who know a lateral candidate, firms can discover a wealth of information about the size of the candidate's book of business, how they obtained it and how portable it is likely to be, in addition to other red flags that, in some cases, make failure predictable—and avoidable.

The third conclusion we can draw is that it's vital for law firms to go into their lateral partner searches with two Ss: a strategy and a story. Lateral hires work best when they are aligned with a strategic plan to grow a particular practice area. Firms with lateral success rates of more than 70 percent often hire to fill clearly identified "strategic gaps," rather than hiring opportunistically to merely add revenue.

Hiring based on a strategic plan works well, in part, because it equips the hiring firm with a convincing story that it can tell both the lateral candidate and the existing partnership about the hire. Lateral candidates who fit the needs identified by a thoughtful strategic plan are going to feel more wanted than the far larger group that could be sought only for their billings. They will also be able to see how their own success contributes to the success of the firm, aligning the individual and the firm in the pursuit of a larger goal. Likewise, when firms can articulate the importance of a lateral hire to their existing partners, those partners are far more likely to tolerate some level of "overpayment" for them. At minimum, it may increase the length of the leash that management is given before the lateral hire's success begins to pay off for everyone.

These benefits do not eliminate all the identified risks. Even law firms with the best stories behind their lateral searches will still have to pay market rates—or very close to it—for the talent they attract. But they do mitigate many of the risks that most commonly undermine lateral partner hires. Law firms that come to their searches with a strategy and a story, at least, can breathe a little bit easier.

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