Kowalski&Associates

The latest from our blog: ***www.kowalskiandassociatesblog.com***

Due Diligence in the Lateral Law Firm Partner Movement in 2011: Buyers and Sellers Beware

Jerome Kowalski

Kowalski & Associates

January, 2011

Despite admonitions concerning the imprudence of predicting the future by such luminaries as John Kenneth Gailbraith ("the only purpose served in making predictions about the future is to lend credibility to astrology") and Yogi Berra ("the future is hard to predict because it hasn't happened yet"), I tremulously recently ventured forth with some predictions regarding the market for lateral law firm partners in 2011. In that piece, I noted that all lateral law firm partner

movement in coming months and years will be marked by heightened due diligence which will be meticulously analyzed -- by both sides.

Gone are the days when lateral candidates enjoyed a few "touchey – feely" meetings and presented some numbers on the back of an envelope.

Here is a brief overview of due diligence issues (more regarding this topic is covered in my book, Navigating the Perfect Storm: Recruiting, Training and Retaining Lawyers in the Coming Decade (Ark Press, 2010)):

1. Begin with more than a resume. The traditional CV has little, if any place in lateral recruiting. The key facts that a firm initially wants to know about a potential lateral are
    a. Practice specialty;
    b. Post law school employment history;
    c. At least three year's revenue production history;
    d. The candidate's top clients;
    e. The candidate's hourly rates;
    f. Why the candidate is seeking a new home;
    g. The candidate's compensation history; and
    h. The candidate's compensation expectations.
2. The names, status, compensation and hourly rates of each lawyer the candidate would like to bring along with him or her (bearing, of course, in mind the ethical proscriptions of recruiting associates before a lawyer has tendered his or her resignation to his or her current law firm).
3. The candidate's plans for continuing to maintain and grow his or her own practice, particularly within the framework of the firm considering the candidate. In this regard, the candidate should deliver a customized business plan for the acquiring firm of his or her plans for expanding his

or her business, given the capacities of the new law firm. Professional intermediaries, such as our firm, with proven track records of mergers, branch office openings and practice group acquisitions have considerable expertise in assisting the parties in preparing such business plans.

4. A thorough analysis of the candidate's historical business production, clients (establishing that he or she has a steady and consistent stream of loyal financially viable candidates) is essential. Matters to be considered are, among others:
    a. The historical trends of business delivered by each client. Questions to be considered are whether particular clients are trending downward, either within their own industries or whether the candidate has been losing business to competing law firms.
    b. Hourly rates paid by these clients.
    c. Average turnaround on accounts receivable.
    d. Client concentration: Firms should be leery of significant client concentration. In the event a single client or related group of clients results in 15% or more of a candidate's business demands close scrutiny, since the loss of that business, for any reason, would be extremely material.
    e. The financial strength of the key clients.

Traditional resumes standing alone are of little help; they are the hallmarks of job supplicants and are the safe harbors of those who segued their callings from placing associates and paralegals to the realm of partner placement. Successful lateral placement of partners requires a substantially broader skill set, including an in depth knowledge of law firm economics and particularly the model of the law firm in the current era.

Due diligence in this market is far more critical than ever, both by the

law firm and by the candidate. A lateral law firm candidate who purports to be a multi-million dollar producer necessarily relies on a cadre of others to manage client matters, particularly if the work originated is outside his or her areas of expertise. These other partners will have developed relationships with the clients. This simple fact must be measured against the desire of an acquiring law firm to minimize the size of incoming groups in order to, among other things, (a) minimize the cost of the incoming group, (b) use the inflow of work brought along be the new lateral to add work to currently under utilized resident associates and partners, (c) better integrate and institutional new clients and (d) prevent creation of silo practices.

By the time a dialogue with a potential lateral candidate is proceeding to this stage, the lateral candidate should have already delivered not only a list of his or her clients, but also a detailed matter list. The individual matter list should be fed in to the firm's conflict clearance program (nothing sours a potential combination more quickly than a client conflict; more time is wasted because these conflicts are not identified early on then could ever be rationally explained).

Each matter of significance should be reviewed in detail. Particular focus should be zeroed in on matters outside the lateral candidate's areas of practice. The candidate's hands on involvement in these matters must be carefully vetted. While the client may "belong" to the candidate, if the pending matter proceeded under the management of a partner in a different discipline to the point that a client, notwithstanding its loyalty to the candidate, may simply assert that it would be contrary to the client's best interests to move the matter to a new firm and that revenue stream may be left on the table as well as any follow on work on that or related matters. Practice leaders of the acquiring law firm should be directly involved in the discussions with the candidate regarding particular matters within the purview of that particular practice area. These discussions will provide some

degree of comfort as to whether these matters will actually be delivered as anticipated, but also aids in both a smooth transition and assists substantially in the integration and assimilation of the candidate in the culture and practice of the acquiring law firm.

Accordingly, a review of prior history should include acquiring a thorough understanding of which partners had matter responsibility in the past. The questions should be obvious: Are you prepared to bring along service partners? An affirmative answer simply requires an increase in the investment. Such service partners, if left behind, for their own survival, will make strong pitches to the clients that such clients continue to have them handle the work, for which they have demonstrated previous expertise. They will caution the clients that moving their work to a new firm will increase the client's fees as new lawyers will have to first familiarize themselves with files, matters and new clients. A wise firm which is advised that a significant rainmaker is jumping ship will assist these service partners in these efforts. Management will join in the bear hug. They will actively participate in these client bear hugs. They will also be prepared to offer a more attractive fee schedule or fee arrangement to build greater loyalty to the firm. Service partners may be encouraged to stay at their old firms and will be offered incentives for retaining clients.

Firms will be less likely to waive partnership agreement mandated notice requirements and require the departing partner to remain at the firm until the expiration of the partnership agreement's advance notice obligation. Some have and will also severely restrict the departing partner's activities and file access during the waiting period; even going to the extent of requiring the departing partner to leave the office during the waiting period so that clients will be more amenable to the bear hug. Others have and will severely restrict the partner's activities during this waiting period. Accessibility to client files will likely be

restricted. Twenty years ago, as partners began to make plans to leave his or her firm, during the weeks before formal notice was given, the partner would begin the process of taking home large litigation bags each night, stuffed with important client files. The vast explosion of data in this digital era frequently makes these exercises virtually impossible. Rather, the litigation bags are now being replaced by cloud computing facilities such as www.dropbox.com. *However, in all events, all involved should first seek counsel regarding all relevant legal and ethical issues involved.*

Law firms have already made note of this strategy when one of its own significant rainmakers announces that he or she is pulling the ripcord. Law firms are also now giving serious consideration to amending their own partnership agreements to extend such notice requirements so as to protect their own assets. In the same vein, law firms are also extending the time period in which capital accounts are repaid to departing partners.

Part of lateral partner due diligence must include checking references, at the appropriate time, which should obviously be after an offer is made and the offer should also be subject to positive references. Be assured that no potential partner will ever identify a reference that will provide anything other than a glowing recommendation. Accordingly, firms should develop a strategy for speaking to others with whom the partner has crossed paths. Most often, intermediary firms, like ours, with a deep network within the legal community, are tasked with this delicate assignment requiring great discretion, and many years of experience evokes both candid and honest responses, as well as a strong assurance of confidentiality for both candidate and law firm. These inquiries must be discrete and carefully couched, for every obvious reason.

I am frequently surprised that so many firms neglect to do a thorough Google search at the earliest part of discussions with a lateral partner. I am even

more astonished that potential laterals do not conduct their own Google searches of themselves so that they can be forewarned of potentially embarrassing information in the public domain that will require some explanation.

Law firms should also, within ethical constraints, meet with and speak to major clients. But before they even get there, the firm must have vetted, more carefully than ever before, far more detailed financial disclosures potential partners provide. Lateral partner questionnaires, which every firm requires, are now being reviewed and scrutinized so as to require more detailed prior performance, future projections and call for a business plan. No candidate should be considered in the absence of such a business plan. Any experienced and competent intermediary will be sure that such a business plan constitutes part of a candidate's submissions.

These questionnaires should be submitted in two parts: The first, after initial screening and meeting with the lateral, should require disclosure of existing clients and adverse parties. These materials should be promptly checked by a firm's department that checks for conflicts of interest for new matters. All too often, as I noted above, the submission of such information is made after a substantial investment in time and energy, only to find that a serious client conflict precludes the lateral from joining the group.

All completed questionnaires should contain an attestation clause confirming the accuracy of the information disclosed and an affirmation that the firm is relying on the information provided in inviting the lateral candidate to join the partnership.

The hiring law firm must also prepare its own pro forma analyzing the investment required to be made in the lateral partner. The pro forma must include assumptions regarding "ramp up" expenses that are, based on an assumption that the new partner will not yield revenues for a period of approximately four months. That assumption is predicated on the simple fact that from the moment the lateral sits down and begins performing work, a billing report will first be prepared by the

end of his first month, a bill generated thereafter remittances will not be made until approximately 90 days. During that period, the firm must pay the new partner a draw, cover compensation for any staff he brings with him and an allocated part of the firm's G&A, as well as any recruiting fee, promotion expenses and any other specialized expenses required by the lawyer. Contingency fees and AFA's must also be carefully analyzed. Prior payment history of clients must also be added to the calculus. Just as with any investment, the pro forma must be analyzed to determine when profitability will be realized and the investment amortized.

It has always been completely remarkable to me that so many lateral partners do not conduct any due diligence regarding the firm they are considering joining. Surely, had due diligence have been routinely conducted by otherwise smart lawyers, Marc Dreier, Scott Rothstein and Harvey Meyerson would each not have been able to build firms of over 200 lawyers.

As partners make one of the most important decisions of their careers, namely, joining a new law firm, there are a host of materials that should be reviewed by them and their advisers: Historical and profit and loss statements, balance sheets, lists of at least the firm's 100 largest clients, including revenues derived from such clients (and the percentage of firm revenues paid by each such client); WIP reports for at least 12 months; A/R and A/R aging reports, the firm's partnership agreement; any applicable pension plans; budget for the current year and, if available, for the following year; the firm's business plan and disclosure of any litigation in which the firm was a named as a party or other pending claims.

Most important, the candidate should engage an independent qualified professional to review these materials and not be the fool who is represented by himself or herself.

Finally, candidates should also make inquiry, directly or through an

intermediary, of partners who have left the acquiring law firm over the course of the past several years. Just as no candidate would proffer the name of a reference who would do no less than extol the great virtues of the candidate, no law firm will have a candidate meet with partners who are either completely enamored with their firms or at least know that it is impolitic to speak poorly of the firm that puts a handsome roof over their heads. Substantially more objective information can be gleaned from former partners and adversaries as well as co-counsel on particular cases or transactions. Information discreetly gleaned through these means must be carefully screened and weighed for reliability: Hell hath no fury like a partner forced to leave nor doth it have any fury akin to an adversary beaten to a humiliating defeat. Thus, the collation of such information is best left to independent trusted intermediaries. Given the stakes at issue, a candidate may well be best served by engaging an independent professional for this exercise, so that no opinion could be tainted by a contingent fee received by an adviser making a placement.

In the coming months, as occurred last year, firms will also be seeing many partners who will explain that they are leaving their firms because (a) they have great opportunities which they are not able to exploit at their current firms; (b) they are not getting adequate support from their current firms; (c) they actually have the client relationships although others receive origination credit because of historical anomalies; (d) their firms are in financial extremis or (e) their firms are not amenable to alternative billing requirements that clients are requiring. Firms will also see partners seeking life rafts when the two or three large firms will inevitably implode this year. There will be many gems among this group of potential laterals, but the wheat must be very carefully separated from the chaff. Rest assured firms will see much chaff. Lawyers correctly take pride in their due diligence skills, investigative abilities and finely honed discovery techniques on

behalf of your clients. These skill sets must be deployed to the fullest extent in this market on their own behalves in this market.

Then, once the deal is struck, the critical next step is the preparation of a practice integration plan. It surely no longer suffices to have a new partner or group of partners show up on the starting date and simply be given a tour of the offices with quick introductions to new colleagues and several luncheons along with thirty minutes with an office manager to merge a practice. The merger integration plans necessarily must include matter transitions, staffing, and orientation to new systems, all in explicit detail.