Laterals, Beware the Capital Loan Honey Trap (Perspective)

(Editor's Note: The author of this post is the former office managing partner of a major law firm and is now a business lawyer and consultant in Southern California.)

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A 'honey trap' is a classic stratagem in which irresistible bait is used to lure a victim.

Everywhere you look in nature, you will find the honey trap. Venus flytraps, angler fish, snapping turtle tongues. Human beings use the technique in almost every form of endeavor, including government, politics, espionage, business, and of course the business of law.

Lateral partner recruiting strategies at some firms have employed the honey trap to the great disadvantage of lateral hires, and ultimately in some cases to that of their entire firms.

It is a competitive market for partner talent, and by definition the 'winner' of the competition for talent usually has to be the firm that offers the most. It doesn't have to be a lot more, but it has to be more — and it has to be attractively packaged to distinguish the deal from other offer opportunities.

While 'most' isn't always money, the honey trap described here appeals to it.

Let's take a look at just one example, the law firm sponsored 100 percent capital loan with zero interest.

First, the firm offers a lateral candidate more compensation than they are worth to get them in the door.

Second, the firm offers the candidate a 'guarantee' of eye popping income for three years.

Third, the firm offers a 100 percent capital loan to the candidate from a bank for a term of five years with interest only payments, followed by a five year amortization of loan principal, and the firm commits to pay the interest for the first three years.

Fourth, a tri-party arrangement including the firm, the bank and the partner requires all capital returns by the firm go first to the bank until such time as the loan is fully repaid, and thereafter capital return payments can be made to the partner.

The lateral candidate thinks about that concept and probably thinks: 'Wow. I feel the warmth, this firm really wants me. And the deal! Nothing up front, the loan interest is paid by the firm, it feels like a capital free deal. If it works out and this is the right place for me and my practice, I will be happy and able to afford that loan, five years down the line, by paying over an extended additional five years those installments of loan principal.

Or the lateral thinks: 'Conversely, if it doesn't work out for me, then I can just pick up and leave and the law firm pays my capital account back to the bank. I am out of it free and clean, my capital is not held hostage so nothing to hold me. My old firm should pay back my capital within eighteen months, and that is a tax free return of capital in addition to my new guaranteed higher income! How could I not make this deal?'

Assume the new partner delivers in every respect the billable hours and originations presented during the recruitment process.

The new lateral partner funds the infusion the firm really needs and wants — the capital contribution, which is tax free cash to the firm.

If the firm offers $3 million annual guaranteed compensation, then at a fairly typical 36 percent capital to compensation ratio, the firm receives $1.08 million on the first day the partner comes to work.

But the lateral partner does not receive the 'guaranteed' compensation amount, in the first year. How can a partner be paid less than was 'guaranteed'? Because elsewhere in the firm partnership agreement or 'policy' is a provision that gives management the power to 'defer' amounts on guaranteed contracts in years that the actual income is less than the budgeted income for that year.

Meanwhile the firm collects all of the new lateral partner generated receivables for a year or two or three years with the use of 'deferrals' of guaranteed compensation.

The partner then learns that the firm has been consistently optimistic about forecasts of financial performance and the 'targeted income' of partners is rarely achieved. These 'aspirational' budgets effectively raise the capital to compensation ratio to above 40 to 50 percent, and present little possibility of the guaranteed amounts being paid in the near term.

The return of capital provisions in the partnership agreement state that any partner who voluntarily withdraws will forfeit all accrued but undistributed income as at the effective date of withdrawal for a voluntary withdrawal, including guaranteed amounts.

It may also provide that a partner's income in the year of withdrawal will be calculated from the start of the year. If a firm pays partners a draw of 50 percent of 'targeted income,' every partner will be overdistributed in the first two to three months because of lower collections in the early months.

Furthermore, when they get into the position of having accrued income in excess of draws received, usually starting around the middle of the year, the partners don't receive it unless they stay through the end of the calendar year.

The solution would seem to be to give notice of withdrawal effective Dec. 31 or Jan. 1. But if the required withdrawal notice is 60 days or 75 days, and the firm has the standard ability to accelerate the withdrawal date — say if a partner gives notice on November 1st for a December 31st withdrawal — the firm can accelerate to November 10th.

The massive year-end collections allocation that the partner would have received will be lost to the partner, and probably 30 percent or more of that remaining 50 percent above draw levels will be gone. If the partner gives notice Jan. 1, the firm can hold the partner until the end of February, and most of the draws received in that first two months will have to be disgorged, effectively compelling the partner to work for free, while generating substantial accounts receivable for the firm.

Year four begins, and the partner now must start paying interest on the loan. The interest rate is low and the partner still has two years before any principal payments are required. Unfortunately, there is no longer a 'guarantee' and perhaps the level of income is reduced to match up to the levels of legacy partners.

The firm each year enthusiastically exhorts to the partners that the tough sledding is almost over and next year will be the year that we can meet this very 'realistic and conservative budget,' unlike last year.

The now disgruntled lateral partner takes a closer look at the partnership agreement, and sees that upon withdrawal the firm policy is to return all withdrawing partner capital within three years. A cautious inquiry with other partners reveals that expected monthly payout from the firm to the bank and then to the partner is not what the firm does.

Instead, the policy is to pay 100 percent of the capital at the end of the three years. Thus, a partner will be on the hook to pay interest for two more years, and then one year of principal and interest to the bank, which works out to $220,000.

Then, a reading of the loan agreement with the bank clarifies that the bank may accelerate the maturity of the entire loan upon a partner leaving the firm. How can the partner pay back $1.08 million plus come up with capital for a new firm to move to?

A lot of partners will grit their teeth and want to believe their leadership that all the costs and burdens are behind us and great gushers of money await — next year. Then the partner will get all current targeted compensation, and a lot more in the deferred guarantee amounts.

It should be clear that the aggressive compensation was an illusion, and now the partner is trapped, having received less compensation than promised, perhaps much less than the partner was earning at a prior law firm.

Infusion of cash from multiple sources including new partner capital helps the law firm to meet its obligations to stay afloat. The firm doesn't have to use the new partner capital to pay down working capital loan debt. Instead, the firm uses it to pay operating expenses, returns of capital to other partners, distributions to partners including the new partner, and maybe some interest or principal on the working line. It doesn't matter where it went, the money is gone.

Should the firm fail and go bankrupt the lateral entry partner owes the full amount of the personal capital loan to the bank. The deferred compensation is gone. Claw-backs for distributions to partners during an insolvent period prior to filing bankruptcy will further beset the partner.

Should the firm confront failure and engage in a liquidating merger where it is acquired by another firm, it is likely that the terms will include a significant write down of partner capital for the partners in the acquired firm, that additional capital commitments will be required of them, that compensation levels will be reset down even further, and that various minimum terms of staying with the combined firm will be necessary or else further penalties and forfeitures of income and capital may be assessed should partners depart early.

Beware the law firm capital honey trap. And please note, this isn't the only one.