Pricing the purchase of lateral talent

By Edwin B. Reeser

This article is the first in a five part series examining the cost to a hypothetical law firm of lateral lawyer hiring.

Once rare, the lateral movement of partners between major law firms is now almost a daily occurrence. Some hires succeed, but studies show a majority of hires, whether individuals or groups, are not successful. Let's briefly examine the basic economics of lateral hiring, and draw fundamental conclusions thereon.

To simplify the analysis and add to its digestibility for readers, we will use four classes of talent, and make basic assumptions about costs, the variables of which can be adjusted to suit any law firm more specifically. While the variability of assumptions that can be made may fine tune the outcomes for any particular firm, it is unlikely that they will change the conclusions that the examples of this series will arrive at.

Type I is the "grinder" hire, a senior associate, income partner or junior equity partner. The hire is for a labor unit of production for salary, perhaps with a performance bonus. Predicated on existing work, the firm can match salary with reasonably predictable revenue streams, and ensure a profit margin with each hire.

Type II is the "mid-level" partner hire. The firm acquires a grinder plus a gross revenue addition from the portable book of business of this partner, which contributes additional profit to the partnership. As a component of the decision depends on the future fulfillment of the expectation of business to be delivered, this decision is more difficult than the Type I "grinder" hire.

Type III is the "star" partner hire, to acquire a substantial gross revenue addition. Her labor is a consideration, but not determinative. Partly due to greater market competition, and accurately assessing the portable business portfolio, this candidate is the most difficult to assess.

Type IV is the "associate" hire, in the entry to middle experience category, usually before the "tipping point" of reaching profitability for the firm around the end of year three, and well before the typical break-even point at about five full years of experience.

The "Grinder"

There are two primary cost components in lateral hiring, recruiter fees and "pipeline" costs. For a $300,000 salaried attorney, a recruiter fee of 25 percent ($75,000) is typical. "Pipeline" cost is what carries the attorney from the first day of work until she generates stabilized cash flow from her own labor, which many firms consider to be 90 days. Assume she arrives and starts recording billable time Jan. 1. The firm processes invoices for January time by Feb. 15 (that is optimistic). Clients receive those bills by Feb. 28, and in this example pay the firm by March 31. A 45-day turnover cycle on A/R from the billing date is pretty good, and while some firms do better, many have a cycle that is at least 10 days longer. Managing A/R is critically important, as a firm with annual fee collections of $500 million generates about $1.4 million in calendar daily collections, and more than $2 million in workday collections when including reimbursements of costs advanced. A 10 day slower collection rate has about a $14 million distributable income impact to this hypothetical partnership. For a firm with 150 partners that is about $93.3k per partner, a huge swing impacting annual results! It is critical because, by this point in the calculation, all of the operating costs are presumed paid. Every dollar collected is a potential distributable dollar of profit for the partners. (An important point in a firm's due diligence therefore is an understanding the A/R performance of a candidate's book of business.)

During this three-month period the "pipeline" is filled with receivables generated by the lateral addition, and the firm pays her $75k salary, plus benefits. The firm expends $150k (salary and recruiter fee), plus the allocable fixed overhead for generating the work. We will use $35,000 for three months for an attorney in this example firm, but it can be considerably higher in some firms, so adjust for your own situation. The "margin" of profit to be expected from this attorney with expected production of 1,950 billable hours, at $450 hourly, is $877,500 recorded, less 8 percent for pre-bill adjustments, less 7 percent for realization rates on billings, for net collected $750,789. (We are not including cost reimbursements, and you can adjust for your own realization rates.) Quarterly that equates to $187,697. Take the annualized $750,789, subtract annual per attorney overhead of $140k, salary of $300k, benefits and employer costs of approximately $60k, and projected annual gross margin or "profit" is $250,789.

The firm reaches breakeven on the investment in this lateral addition in a little over a year, thereafter receiving net benefit to cash flow and profits of about $250k annually. The first year the impact is a small net loss, because the firm only gets cash returns for nine months due to the "pipeline" of 90 days. Only $563,091 was actually collected, notwithstanding she hit the ground fully engaged and productive on Jan. 1. For partnership accounting and tax purposes we actually will report about a $12,000 loss for the year. That is assuming it worked as optimally planned above. To the extent it takes time to have her fully engaged with work, obviously the returns to the firm are less.

What is the impact of a delayed start? For an April 1 start date the recruiter fees and pipeline are unchanged, but cash flow is only for six months. For this level grinder the impact to the bottom line is approximately $75k negative. Start July 1 and the negative impact is about $137k. Start Oct. 1 and the impact is about $200k reportable loss for the year. No wonder the job market can be difficult for lateral mobility of talented "grinder" attorneys, especially late in the fiscal year, even though they contribute significantly to profits relatively quickly. Recall the move by some law firms to defer the start date of new associates to the following year? It makes some sense, at least as an effort to respond to a squeeze on reportable partner income. (It isn't a solution to that problem, only a response with a one-year benefit, but if a firm pushes 30 associate start dates from Oct. 1 into the new year...do the math and see the impact.)

Predicated on existing work, the firm can match salary with reasonably predictable revenue streams, and ensure a profit margin with each hire.

Done properly, payback on hiring cost is relatively short and returns are good for hiring a grinder. If the firm requires a "capital" contribution from income partners of $20k-$50k, or goes to a "one tier" form of structure and converts income partners to equity with a $150k equity capital contribution (turning away from the AmLaw PPP "derby" in which firms chase a brass ring of prestige associated with having the highest possible PPP), the firm achieves more flexibility as to timing hires, and the previous cash burden is actually converted to a significant cash boon to the law firm. The new hire effectively pays all recruiter fees and fixed overhead for the pipeline period with their own capital contribution. Only the salary/draw is covered by the law firm. If the partner is in a junior equity class with a 60 percent of budgeted annual income draw program, this cash flow from undistributed profits is even lower. This arrangement strengthens the firm's financial condition with a larger profit pool and lower salary costs, unless the benefit is used for current year distributions to the upper levels of the equity partner class. (A bad decision!)

So, does it make sense to hire at this level? The simple answer depends on whether the "grinder" can be put to full utilization immediately, and for a term of more than a year. If the answer is "yes," the hire becomes a contributor of $250k of distributable partner profit annually. Assuming a 600-lawyer firm, with 150 equity and 150 income partners, and 300 associates, the income partners contribute $37.5 million to partner profits, and increase PPEP by $250k. Senior associates are also robust contributors. Junior equity partners whose primary function is as service partners are allocated profit share computed as though they are salaried. That makes for a resounding "yes" conclusion.

The next installment in the series will look at the mid-level equity partner candidates, and investigate whether the firm makes any money from them. The answer might surprise you.

Edwin B. Reeser *is a business lawyer in Pasadena specializing in structuring, negotiating and documenting complex real estate and business transactions for international and domestic corporations and individuals. He has served on the executive committees and as an office managing partner of firms ranging from 25 to over 800 lawyers in size.*

Suit to speed executions hits bump

By Henry Meier
Daily Journal Staff Writer

The 3rd District Court of Appeal dismissed a lawsuit brought against the state for failing to execute death row inmates who have exhausted the appellate process.

The justices did not give a reason for the dismissal. Kent Scheidegger, legal director of the Criminal Justice Legal Foundation, which filed the suit, said the state keeps finding ways to delay executions.

"They're just dragging their feet, is all it amounts to," Scheidegger said. "Six years it's been tied up on something that should have been decided in a matter of months."

Scheidegger, who filed the case along with former governors Pete Wilson and George Deukmejian, said they have not officially decided whether to seek review by the state Supreme Court.

"We haven't formally decided whether we'll appeal, but we most likely will," he said.

The suit, *Winchell v. Cate*, C070851 (Cal. App. 3rd Dist. April 19, 2012), was an attempt to force the California Department of Corrections and Rehabilitation to explore the use of a one-drug method of execution, something it has resisted because only the three-drug procedure has been approved by the U.S. Supreme Court.

However, the state is currently banned from using its traditional three-drug cocktail by both federal and state court orders, which have led to a moratorium on executions since 2006.

CDCR public relations officer Jeffrey Callison said the agency's legal staff had not had time to review the case and were reserving comment.

'We haven't formally decided whether we'll appeal, but we most likely will.'

— *Kent Scheidegger*

The case is part of a broader referendum that's playing out in the state, as proponents and detractors of capital punishment gear up for a November ballot initiative that would end the death penalty in California and replace it with life in prison without parole.

henry_meier@dailyjournal.com

California judge charged with elder theft

An Alameda County judge has been arrested on suspicion of stealing at least $1.6 million from his 97-year-old neighbor after taking over the management of her and her husband's finances, authorities said.

Paul Seeman is scheduled to be arraigned Friday on charges of elder theft, according to court and jail records. He was arrested a day earlier at the Wiley Manuel Courthouse in Oakland after a months-long investigation by Berkeley police.

Seeman, 57, is accused of fleecing Anne Nutting, his neighbor in Berkeley, following her husband's death in 1999, allegedly selling two properties the couple owned in Santa Cruz after taking over as their power of attorney.

By 2004, he had assumed control over almost all of Nutting's financial affairs, according to investigators. They say he sold off her art and other possessions, stored his 1957 Ford Thunderbird in her garage and tried to bar her from returning to her home.

He also persuaded her to loan him $250,000 at 3 percent interest, but only made eight payments on the loan until he was contacted by police, according to authorities.

Nutting died in 2010. Police began investigating the case after they were contacted by an attorney she had hired to try to regain control over her financial affairs.

"The alleged conduct of Judge Seeman is disturbing and disappointing," said Teresa Drenick, spokeswoman for the Alameda County District Attorney's Office.

—Associated Press

Dispatches from the reading room: laughing out loud

Life in the Law

"Life in the Law is a weekly column discussing issues lawyers encounter in their daily lives and practices"

By William Domnarski

Who would have thought that as we traverse what Justice Benjamin Cardozo called the "Sahara of the judicial opinion" we would find the occasional bubbling spring providing relief in the form of humor. It takes many forms, ranging from tired jokes to sly wit to satire so powerful as to make us laugh. To invoke Samuel Johnson, we can say that, while it might not be done well, it is a surprise to find it done at all.

The oddities and curiosities that dot the Federal Reporter do not qualify as humor if intention is a requirement, but they amuse nonetheless. One example is a trademark dispute brought luxury handbag maker Louis Vuitton against the maker of plush dog chew toys using the name "Chewy Vuiton." Another would be the copyright infringement case involving the plush doll known as Pull My Finger Fred. Fred is a white, middle-aged, overweight man with black hair and a receding hairline who sits in an armchair wearing a tank top and blue jeans. His talent is that he farts when the extended finger on his right hand is pulled and makes "somewhat crud, somewhat funny statements about the bodily noises he emits, such as 'Did somebody step on a duck?' or 'Silent but deadly.'" His plush doll rival, Fartman, has the same physical and sartorial characteristics and also sits in an armchair. He too farts when his extended finger is pulled and comments on his emissions.

The nature of the cases themselves sometimes provide humor with their ludicrous claims. In an example from the D.C. Circuit, a group of lactose-intolerant individuals filed a class-action lawsuit against nine sellers of milk. The court politely called the suit unusual. The claim was that the plaintiffs consumed milk before they were aware of their lactose intolerance and, as a result, suffered temporary gas and stomach discomfort. In the plaintiffs' world, the milk sellers should have put warnings on the labels to inform consumers that some individuals might be intolerant of milk. Those "falling rock" signs we see should probably also warn us about gravity. Lunacy, too, can make us smile. In a D.C. Circuit case the defendant, according to the court "had a goal: to collect two of every kind of computer or, as he phrased it, to build the 'Noah's Ark of Computer land.' Unable to buy such a collection, he decided to steal it. Over 10 years, he pilfered 19,709 pieces of computer equipment from his employer, the Naval Research Laboratory." No word on how many lawyers the defendant had.

Judges seeking to amuse have their own motives. Sometimes it is just a byproduct of indignation, frustration, and a view that the world has fallen into chaos can produce its own humor. Judge Terence Evans of the 7th Circuit begins a Lanham Act case this way: "Toilet paper. This case is about toilet paper." After describing the impressive litigation efforts of the parties Georgia Pacific and Kimberly-Clark, Evans wryly notes, "That's quite a record considering, again, that this case is about toilet paper." In a class action attorney fees case, for example, the Judge Edward Earl Carnes of the 11th Circuit uses humor as a pitchfork and chides the attorneys for the plaintiff class by invoking well known phenomenon of financial insatiability. The opinion begins, "When asked how much money would be enough for him, John D. Rockefeller reportedly said: 'Just a little bit more.' The attorneys for the plaintiff class want more than just a little bit more." Not surprisingly, the lawyers did not get their little bit more.

After describing the impressive litigation efforts of the parties ... Evans wryly notes, "That's quite a record considering, again, that this case is about toilet paper."

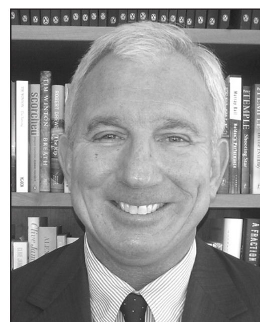
Judges can be drawn to what might be called one-liners that deliver a humorous punch. In a tax evasion case from the 7th Circuit in which the defendant, a luxury car salesman, embezzled hundreds of thousands of dollars from his employer and did not pay the government its tax share. Judge Evans frames the case in the opening sentence by writing that "This is the kind of case that could give a car salesman a bad name." Hyperbole can be used for trenchant effect as well in the one-line arena. In an 11th Circuit sentence review case involving a defendant who started at 13 with a blaze of criminality and just kept on going, Judge Carnes notes first that the defendant's "rap sheet long is enough to require extra postage" before identifying the sad fact that the defendant's repeated arrest and various prison terms over a 15-year period make it look as though the defendant "is determined to serve a life sentence, albeit on the installment plan." The question before the court was "whether the current installment is a reasonable one."

In contrast, we can more subtle and even erudite humor in the advance sheets. In a 9th Circuit in which Brian Love of the Beach Boys sued former band member Brian Wilson and a British newspaper that distributed a CD of Brian Wilson's solo performances of Beach Boys songs as part of a promotion campaign for Wilson's British tour, the issue was whether the Lanham Act could be invoked extraterritorially. Judge Sindey Runyan Thomas concluded the introduction portion of his opinion by stating blandly enough that "the central issue before us is whether American claims for relief can be asserted on the basis of conduct that only occurred in Great Britain." He follows this with the unremarkable, "the defendants think not." The next sentence joins the issue and jumps off the page with its playful knowingness: "Love wishes they could all be California torts."

One judge cleverly and amusingly uses Shakespeare to add a bit of spice to an opinion. In a freedom of speech case involving, of all things, the annual Garlic Festival held by the city of Gilroy, California, the judge notes that 120,000 visitors attend the festival each year and that since its inception more than three million people have attended, to partake, as described in the festival's promotional materials, in food laced with over two tons of garlic. This prompts the judge to wryly note that in holding the garlic festival, the city was disregarding Shakespeare's admonition in "A Midsummer's Night Dream," which in a footnote is set out: "and, most dear actors, eat no onions nor garlic, for we are to utter sweet breath."

There are attempts at humor that do not succeed, some less than others. Consider Judge Juan Torruell's use in a 1st Circuit case of a well-worn amusing observation. "This case, involving the saga of an extremely frustrated boat owner, provides further support for the occasionally expressed view that the two happiest days of a boat owner's life are the day he buys his boat and the day he sells it." And Judge Richard Cardamone falls even flatter in a 2nd Circuit Wild Bird Conservation Act case involving the rare Black Sparrowhawk. After noting that there have been few, if any, prosecutions of the act, Cardamone, as part of his general observation that the case before the court was unusual in various ways, goes esoteric on us. He tells us that "judicial opinions often characterize an odd provision of the law or an ingenious argument as a 'rare bird' (*rara avis*). But in this case we have before us as the subject matter literally a *rara avis in teris* or a rare bird on the earth." Long walk, little joke.

That there are many misses as hits makes us appreciate an explosion even more. In a civil case from the 7th Circuit the plaintiff's lawyer cleverly got around contrary precedent by simply ignoring it. He never mentioned the case in multiple submissions, all of which followed the publication of the damning precedent. This is a recognized phenomenon in the profession, judging from the several opinions in which lawyers are described as metaphorically acting as ostriches. Richard Posner rehabilitates the reputation of the ostrich in his opinion by noting that ostriches do not really hide their heads in the sand as an avoidance mechanism, but he takes the public's understanding of what ostriches do, or rather their misunderstanding and makes sure that the plaintiff's lawyer gets the point. On the last page of the opinion he places two black and white images, each taking up half the page. On the top is an ostrich with its head in the sand. On the bottom, there is a man dressed in a business suit (our lawyer presumably) with his head in the sand. LOL.



William Domnarski *practices law and hires out as an editor. His latest book is Federal Judges Revealed (Oxford, 2009). He can be accessed at www.williamdomnarski.com.*

SUBMIT A COLUMN
The Daily Journal accepts opinion pieces, practice pieces, book reviews and excerpts and personal essays. These articles typically should run about 1,000 words but can run longer if the content warrants it. For guidelines, e-mail legal editor Ben Armistead at ben_armistead@dailyjournal.com.

WRITE TO US
The Daily Journal welcomes your feedback on news articles, commentaries and other issues. Please submit letters to the editor by e-mail to sharon_liang@dailyjournal.com. Letters should be no more than 500 words and, if referencing a particular article, should include the date of the article and its headline. Letters may not reference a previous letter to the editor.

Pricing the purchase of lateral talent

By Edwin Reeser

In the first installment of this series we investigated the profitability of the "grinders," and found them to be solidly profitable when managed properly. This installment will focus on the partner with a solid work ethic and a respectable coterie of loyal clients.

The Mid-Level

Let's hire a partner with a $2 million business book. The partner's hourly rate is $700 with 1,900 billable hours recorded. The partner records $1.33 million of work time, and using the same billing and realization assumptions from Part One of this series, he bills $1.22 million and collects $1.14 million. He bills time for lawyers working on his matters, including one mid-level associate that he brings along, and some work given to other associates already at the firm, collecting $860k. He is allocated compensation of $600k from partnership profits for that package. Capital contribution is 40 percent of his annual projected profit share, or $240k. The recruiter fee is 25 percent of draw (not projected total annual income). At 55 percent draw, that is 25 percent of $330k, or $82.5k. (If the arrangement is on total projected compensation the fee will be $150k, so one can add $77.5k costs to the totals below, but it won't change the conclusion for this firm.)

TWO IN A FIVE PART SERIES

Part one appeared on June 18. The series is collected at www.dailyjournal.com.

Per capita attorney overhead is $35k for the quarter, the recruiter fee on one accompanying associate is $45k, so we have $197.5k cash cost. Pipeline cost is another $60k for the associate. For the partner, at a 55 percent draw rate on projected income of $600k, another outlay of $82.5k (600 x .25 x .55), for a total of $127.5k. Bottom line, the firm is cash flow out of pocket $340k in the first 90 days. The expense is less because the partner distributions are not salary, but advances against the partnership profit pool, so expense is $257.5k. Net contribution to profit is projected at about $400k for a full year from this hire based on his own billable time (less overhead and his own full year profit distribution), and another $275k from his seasoned mid-level associate and work given to other attorneys in the firm (using an industry standard of 32 percent margin on collected fees-again you can adjust to match up to your firm's historical ratio).

> This class of partner is a dynamic contributor to profits to the enterprise, sustaining themselves and delivering significant positive cash flow as well as distributable profits to the other members of the equity partner profit pool.

However, as was the case we examined in Part One, only nine months of cash flow will come to the firm in the initial 12 months. Accordingly, we adjust to $1.5 million of fee collections, but a full year of expenses for both the partner and associate. The $675k of projected profit is reduced to $175k of profit. The firm has paid out $127.5k in recruiter fees, and thus the first year profit delivered in this example is $47.5k.

This mid-level partner in our example is a net contributor to the profit pool of the partnership even with the reduced collections for an initial year. For the second full year, this mid-level hire is putting in about $650k of profits for other partners ($400k on his own time and $275k from his associate) and taking out $600k. With an initial outlay of $242.5k of overhead, recruiter fees, and "pipeline salary" for the associate, does it make sense to hire the mid-level? How about if we add another $77.5k in recruiter fees?

We have many things to consider, but let's simplify and concentrate on only two: cash flow and reportable income. From a cash flow perspective, assuming a Jan. 1 start date, this lateral candidate will put $1.5 million in the firm's coffers by Dec. 31. He takes out $600k in profits distribution, $280k for overhead for himself and his associate, salary and benefits of about $240k for his associate, and $127.5k in fees to the recruiter. That leaves $252.5k in positive cash flow. From a profits perspective, using a straight cash basis of comparison, the numbers are the same, except profits are $852.5k of which $600k is allocated to him. If the overhead allocation per attorney were more, say $200k per year instead of $140k per year, the additional $120k for the team is still below the net contribution. Throw in more recruiter fees, and he is still a net "win." That is a pretty good addition for our example law firm to make.

Now consider this: the lateral partner contributed $240k in capital, used as the cash to facilitate the transaction. The firm used the capital contribution for recruiter and overhead costs. That leaves "pipeline" costs of about $2,500. $82.5k of the distribution during the first quarter pipeline period to the lateral mid-level partner is actually coming from the profit pool. Now the cash flow profile improves significantly for the initial year, although there is no impact on profit and loss from a capital contribution transaction. Since half of such hires fail within five years, that capital will be returnable to the partner when they depart. But the inclusion of the capital contribution element serves as a significant relief to the firm to make this mid-level addition of a partner, and the contribution to profit is a net addition to this particular partnership, improving reportable PPP.

If the firm capitalizes rather than expenses currently the recruiter fees of $127.5k for the two hires, cash flow is not improved, but "profit" is increased by $127.5k less first year amortization on that asset, which with five year useful life assigned to it is $25.5k. On the books the firm paid $25.5k for the recruiter fee in the first year, and $102k is deferred to future reporting periods. By capitalizing compensation pipeline costs, along with the $70k overhead cost for the 90 days, less the $82.5k in advances of profit share to the equity partner, $130k of otherwise reported expense is converted to an asset, amortized over five years, and the first year cost is a paltry $26k.

Voila', what appeared a decent decision given $257,500 transactional costs is enhanced with "adjustments" to the balance sheet, and impacting the income statement. Partner capital is received without being characterized as income (which is correct), fees are paid with cash from partner capital contributions, and the expense impact reducing earnings from recruiter fees and pipeline costs are recognized only as to 20 percent, or $48.5k, because they were capitalized. The $257.5k in cash is gone, but the partnership net profit is not materially diminished by the hire. The expense remainder will be spread over the following four years. Impact on the income statement is close to neutral, yet the firm has added $1.5 million in gross revenue "growth" in the first year and $2 million in subsequent years.

As this will apply across the board for hires in this category, it makes a modest addition look *much better.* There will be some burden in future years, but it can be rationalized as "bearable" if the lateral partner performs as anticipated. Of course, by the time the amortization period is over there is the historical factor that half of these additions have already left the firm, so while it can be rationalized, it can also defer the day of recognizing that a financial problem is building from a lateral acquisition strategy that has a high turnover rate embedded within. The strongly positive net performance of the aggregate of "winning" additions is likely to be greater than the cost of the aggregate of "losing" additions, even at 50 percent attrition rates over five years. Accordingly, while reasonable minds can differ and debate, the application of this modified cash basis treatment to the mid-level partner hire may not present special risks, as long as the netted performance of the group trend to the positive on a long term basis, through both active and slower periods of growth and lateral additions of this talent class.

Pause from the above, and examine this partner and his contribution from yet another perspective. He is producing $1.14M of revenue (RPL) on his own time. His overhead allocation is $140k per year. That means he is netting out to the firm from his labor about $1 million. But he is being paid $600k, thus he personally contributes net $400k to the profit pool from his own work for others to receive, plus profits from work done by others on his clients. What is really happening here?

Fundamentally, from higher margins on higher billing and realization rates for partners, he delivers higher than average RPL. (If in our hypothetical firm average RPL is $800k, at $1.14M he is well above average RPL). Including a firm average 32 percent margin ($275k) on the work done by others, he delivers almost $675k for others in the partnership to share. That is more than he is getting compensated for work that he controls and brought to the partnership.

The question we return to then is, does it make sense to make a lateral hire at this level? If the book of business is there and the partner can deliver the working hours, the answer is a resounding "YES." This class of partner is a dynamic contributor to profits to the enterprise, sustaining themselves and delivering significant positive cash flow as well as distributable profits to the other members of the equity partner profit pool.

We saw from the first installment in this series that the "Grinder" is a solid contributor to the equity partner profit pool. Now we see that the "mid-level" partner is an even stronger contributor to the equity partner profit pool. This raises an interesting question: who among the partners are receiving that surplus they create?

We shall look at that dynamic when we turn to the more complex "Star" class lateral hires in our next two installments.

Edwin B. Reeser *is a business lawyer in Pasadena specializing in structuring, negotiating and documenting complex real estate and business transactions for international and domestic corporations and individuals. He has served on the executive committees and as an office managing partner of firms ranging from 25 to over 800 lawyers in size.*

May budget revise: not fair, not right

By Mary Thornton House

Prosecutors dream of starting their opening arguments with a discussion of the defendant's criminal history. Second chair associates fantasize about a first chair partner tripping on the courthouse steps, requiring them to save the day with the winning final argument. Government lawyers defending the taxpayer's coffers desperately wish jurors knew the money comes from their taxes.

Lawyers refrain from such tactics because they are not fair, not right and only the subject of the fantastical found in movies, sitcoms and legal thrillers. However, with the May revise budget cutting $544 million from trial courts, the justice system in Los Angeles and throughout California will be pushed into a parallel world that is not fair, not right and forcing "solutions" bordering on the fantastical as we de-construct our already strained court system due to three years of cuts well exceeding the billion dollar mark.

It's a given that we are just one of a multitude of Oliver Twists who ask for more porridge from the disappearing institutional kettle. However, what isn't understood is the human and societal cost of a downsized judicial system and the ripple effect it will have in all areas of the lives of the very citizens that also seek assistance.

Only a few weeks ago, close to noon on a Friday, a lawyer for a private fiduciary rushed into my court with her client beside her. She had a large, older, very dusty file in hand. She pleaded with me to hear her ex parte request. The conservator was dealing with a long-time conservatee — called Paul for our purposes — who was writhing in pain on life-support without a do not resuscitate order or other life-ending instructions. Could I look at the case and issue an order? I read the request and concluded that the Probate Volunteer Panel counsel needed to investigate. My trusty and experienced staff called the prior PVP counsel right away.

Despite a heavy Monday calendar, we set it then — the first opportunity it could be heard because of the intervening weekend. PVP counsel did her job — going to the hospital on Mother's Day to see Paul for herself, interviewing known and available relatives, and appearing on Monday to report to me that everyone agreed that Paul would not have wanted to languish. This was fair and right, and there was no fantasy about ending the pain being experienced by Paul in both an expedient and legal manner. I only wished I could have alleviated his pain in one day, not two.

As the drastic cuts envisioned by our elected officials became a reality on the recently passed budget, the hurdles for persons like Paul will be immense. A post-July 1 clerk's office might not have sufficient staff to even find Paul's file. An inexperienced staff, due to lay-offs and personnel transfers, might not know how to contact all the players to get relief. Long lines for ex parte matters will get longer because reduced staffing will make it impossible to handle the daily rush of regular business, much less ex parte requests. In less than a year from now, Paul's conservator and lawyer will likely have to wait days longer for the relief as such services likely will be curtailed with courtroom and courthouse closures.

Isn't this prediction a tad bit fantastical? No. Even now, the downsized traffic court staff at our Hill Street courthouse issue to persons in line after a certain point in the day Disneyland-like "fast passes." After waiting for hours, people trying to pay their fines are told to come back within the next three days only to get priority in line — with all the others who were given passes. Think about what this "solution" envisions for other justice disciplines: can you imagine handing a "fast-pass" to a domestic violence victim who has waited all day to get a temporary restraining order and telling her to come back the next day? With the inevitable closure of local courthouses, she no doubt had to travel much further to stand in that line, too. Not fair and not right, but nevertheless, it is a probability with the looming budget cuts.

The latest 10 percent cutback in Los Angeles put into full operation on July 1 required lay-offs of 157 employees with reductions in status, pay grade, and transfers for a total of 341 staff resulting in 56 courtroom closures — all done to operationalize past budget reductions. This took months of preparation. The Legislature passed the $544 million in cuts June 15, with deferring as to how those cuts will be implemented. The May revise envisioned a "sweep" of all local court reserves into a statewide master fund. Los Angeles court leaders predict a need to reduce our budget by at least another $42 million, possibly greater, for fiscal year 2012-2013. You do the math in terms of how much the Los Angeles courts must further shrink. Our court administration and judges are doing what they can to make intelligent decisions about how, when and where cuts must occur; but the priorities are fixed by the law and are hard to argue about, as they go to the heart of public safety. Criminal and juvenile have priority, and the remaining juridical disciplines must be evaluated in terms of protecting those most vulnerable. This cannot be done without thoughtful planning and input from all stakeholders.

What is fair? Restore as much of the $544 million cut as possible — at least permit the construction fund money that is generated by the court to support the courts. Give trial courts the priorities for all monies — simply, give the most to those courts that provide the day to day protection for our communities.

What is right? If you can't restore funding, at least give our courts a period of time — minimally a year — to evaluate and operationalize further cuts. Permit courts with reserves to keep those reserves. This will allow local planning based upon local sacrifice and local evaluation of needs and priorities.

Mary Thornton House *is a judge for the Los Angeles County Superior Court. She advises us that this article reflects her personal opinions — and frustrations — only and not that of any other person or organization.*

DEALMAKERS

MERGERS & ACQUISITIONS

Orrick aids in PV purchase

Tokyo-based Mitsubishi Corp. and Osaka, Japan-based Osaka Gas announced plans to purchase a portfolio of Ontario, Canada solar photovoltaic projects from Recurrent Energy. Orrick, Herrington & Sutcliffe LLP represented Recurrent with a team led by San Francisco partner John P. Cook that included San Francisco managing associate Kristin Seeger. The terms of the deal were not disclosed. McCarthy Tetrault LLP acted as Recurrent's Canadian counsel. Shearman & Sterling LLP and Stikeman Elliott LLP were counsel for the buyers, and White & Case LLP acted as counsel for the lender.

Kirkland & Ellis helps in acquisition

San Francisco-based Vista Equity Partners, a private equity firm focused on investing in software and technology businesses, has acquired Boston-based recruiting software company Bullhorn Inc. Bullhorn will operate as a stand-alone company. The next phase of growth will include a focus on increasing Bullhorn's product portfolio and geographic expansion. Kirkland & Ellis LLP represented Vista Equity in the transaction, with a team including San Francisco-based partners David A. Breach, David L. Dixon, Laura A. Rupenian and John Lynn.

Latham advises BioMed Realty

San Diego-based BioMed Realty Trust Inc. acquired Granta Park in Cambridge, U.K., comprising 11 laboratory and office buildings and a total of approximately 472,200 square feet of space, as well as approximately 138,400 square feet of development and expansion rights. The purchase price is valued at approximately $196 million, excluding transaction costs. Latham & Watkins LLP advised BioMed Realty Trust with a trans-Atlantic deal team led by a team in London with support from partners Craig M. Garner and Steven J. Levine in San Diego.

Latham advises Energy Transfer Partners

Latham & Watkins LLP advised Energy Transfer Partners LP in the purchase of an interest in Southern Union Co. sold by Energy Transfer Equity LP. The deal was led by Latham corporate partners in Houston with assistance from Los Angeles tax partner Laurence J. Stein and associate Eric Matuszak. Orange County-based Latham corporate associate Daniel E. Rees also worked on the deal. Through the deal, an Energy Transfer Partners-controlled entity called ETP Holdco Corp. will acquire assets that Energy Transfer Equity gained from the recent merger of Sunoco and Energy Transfer Partners. In exchange, Energy Transfer Equity will gain a 60 percent equity interest in HoldCo.

Sheppard Mullin counsels on Enaqua sale

Denmark-based global pump manufacturer Grundfos Pumps Corp. announced plans to purchase Vista-based water purification company Enaqua. The terms of the deal were not disclosed. San Diego-based partner Stephen R. LaSala led the Sheppard Mullin Richter & Hampton LLP team representing Enaqua. Counsel for the company was also provided by La Jolla-based sole practitioner Andrea E. Migdal. San Diego-based Sheppard Mullin associates Michael R. Leake and Luke Erburu Cocalis also worked on the deal for Enaqua. A team of attorneys from the New York office of Gibson, Dunn & Crutcher LLP represented Grundfos.

Skadden works on newspaper sale

Irvine-based Freedom Communications Holdings Inc., which owns approximately 100 print publications, announced it is selling the Orange County Register and six other papers to 2100 Trust LLC, a privately owned investor group led by Aaron Kushner, former chief executive of Marian Heath Greeting Cards. Skadden, Arps, Slate, Meagher & Flom LLP represented Freedom Communications with Los Angeles-based mergers and acquisitions partner Brian J. McCarthy leading the Skadden team. The terms of the deal were not disclosed. Los Angeles-based tax partner Michael Beinus and labor and employment partner Karen L. Corman also worked on the Skadden team. This deal, expected to close within a month, marks the last piece of the company to be sold. A team from the Boston office of Latham & Watkins LLP represented 2100 Trust.

Send your Mergers & Acquisitions and Financing deals to deals@dailyjournal.com

Clemens is found not guilty in perjury trial

By Juliet Macur
New York Times

Roger Clemens, whose hard throws intimidated even the toughest batters and turned him into one of the best pitchers in baseball history, was acquitted Monday of charges that he lied to Congress in 2008 when he insisted he never used steroids or human growth hormone during his remarkably lengthy career.

The verdict, rendered by a panel of eight women and four men who are largely uninterested in baseball, came on the second full day of deliberations. It was a major, especially painful, defeat for the government in its second failed attempt at convicting a player whose legal problems highlighted baseball's continuing drug woes.

As the counts of not guilty were announced in the courtroom, Clemens bit his lip and appeared to wipe tears from his eyes. When it was clear he had been acquitted, Clemens hugged his wife and their three sons.

Last spring, Clemens' initial trial ended in a mistrial on only the second day of testimony when prosecutors bungled by showing the jury inadmissible evidence. Critics said the prosecution of an athlete like Clemens — a seven-time Cy Young Award winner — was a waste of government time and money, but the U.S. attorney's office in Washington pressed forward anyway.

Clemens had been charged with one count of obstructing Congress, three counts of making false statements and two counts of perjury in connection with his testimony to a House committee about his drug use. Under the obstruction count, the jury had to review 13 statements Clemens made to Congress to determine whether he was innocent or guilty of each one. To convict him on that count, the jury needed to find that he had lied only one of those 13 times. He was acquitted of all charges.

For Clemens, 49, and his family the verdict was a huge victory — and an obvious relief. If he had been convicted on all counts, he would have faced 10 years in federal prison.

For the government, the acquittal was yet another embarrassing disappointment in a string of failures regarding the investigation or prosecution of high-profile athletes.

Examining the real cost of purchasing lateral talent

By Edwin Reeser

This article is the third in a five part series examining the cost to a hypothetical law firm of lateral lawyer hiring.

The prior two installments addressed "grinders" and "mid-level" partners. Both, when admitted properly, are solidly profitable to the firm. Now we analyze the more complex hire of a "star" partner in the next two installments.

The Star, and the Super Star

Let's hire a "star" partner with a $10 million business book, $850 hourly rate and 1,700 billable hours. Assume low pre-bill adjustments of 5 percent on her personal time, and realization on hours of 95 percent for 1,534 collected hours ($1.3 million). Profits allocated to her are $2.75 million, guaranteed for four years. As a working partner she contributes $1.3 million from her labor. She cannot pay herself from personal productivity; that would require almost 3,800 billable hours. The firm must reallocate enterprise profit of $1.45 million originated from "surplus" contributions to profits from other lawyers.

The "super star" has a $30 million business book, $1,000 hourly rate, and 2,400 billable hours, with the same realizations as above. Profits allocated to him are $5 million, guaranteed. As a working partner he contributes $2.17 million from his labor. The firm must reallocate enterprise profit of $2.83 million from surplus contributions to profit.

PART THREE IN A FIVE PART SERIES

Part two appeared on June 19. The series is collected at www.dailyjournal.com.

The aggregate profit from junior associates (as described in Part Five of this series) and grinders will not be enough, so some of their compensation must come from profits generated by mid-level equity partners, from both their labor, and their clients. At $2.75 million, the star's profit share allocation is about 4.5 times our mid-level partner example, and the super star's is over eight times. With the lowest partners paid $400k, the multipliers are about seven and 12.5 times, respectively.

A reasonable profit for a large law firm is 32 percent margin on collected fees ($3.2 million on a portfolio of $10 million, and $9.6 million on $30 million). Margins can vary from the low 20 percent range to the high 30 percent range, so we are selecting a solid, but not spectacular ratio. If your firm is different, plug in your actual operating margin to the example. The lower the margin, the more potentially difficult the viability of additions. Indeed, another serious consideration for the hiring firm is the relative profit margin delivered by a lateral's book of business compared to that of your firm. Absent special considerations, you want higher margin practices, not lower, to be added to your business.

Net of her profit share, the star's book of business has paid for her, and $450k appears to be contributed to the profit pool. For the super star, he has paid for himself and $4.6 million to the profit pool. At first blush, bringing the star to the firm looks like a winning decision, and the super star is a "home run." Typically that is how it is presented and sold to partners for the vote, if there is one. However, that simplistic approach may be inadequate to correctly view these complex hires.

We will use the basic assumptions already set forth in Parts One and Two of this series. The star's capital contribution is $1.1 million, and the super star contributes $2 million.

Since the 2008 recession, most recruiters on larger lateral groups charge nothing for included associates. Let's assume support for our star is one service (no business) equity partner at $600k profit share, two income partners each with $400k salary ($200k fees), and seven associates, with additional work absorbed into your firm's capacity. Total fees to the recruiter are $1,037,500. Associates come without recruiter fees. The service equity partner contributes $240k in capital, for a total of $1.34 million. Group RPL is about $900k.

Our super star has three service equity partners, six income partners, and 18 associates, same terms as above. For 28 lawyers that is a strong group RPL of about $1.07 million. Aggregate capital contribution is $2.72 million.

The star group puts in $1.34 million equity, recruiter fees of $1,037,500 cash "out," plus first quarter pipeline of about $1.7 million ($6.8 million annual on $10 million revenues, apportioned to the first 90 days). Total expenses for the addition are $2,737,500 in the first 90 days, with no income. Furthermore, partner advance draws to our star and her service equity partner are an additional $797.5k. Note that the advance of partner "profit" has to come from the partner profit pool. New lateral partners are not delivering profit in the first quarter, but are taking draws against "profit," so it has to be coming out of the profits of other partner's shares. First quarter cash outflow, net of equity contribution, is $3,535,000 less $1.34 million contributed, or $2,195,000. Capitalizing recruiter fees and pipeline costs of $2,737,500 million with a five-year amortization period, the recognized cost each year is about $547.5k.

The super star group puts in $2.72 million equity, recruiter fees of $2.3 million cash "out," plus first quarter pipeline of about $5.1 million. Total expenses for the addition are $7.4 million in the first 90 days. Partner draws to the super star and three equity partners are an additional $1.7 million. First quarter cash outflow, net of equity contribution, is $9.1 million less $2.72 million contributed, or $6.38 million. Capitalizing recruiter fees and pipeline costs of $7.4 million over five years gives a yearly cost of $1.48 million.

The capital contributions from the star and her equity partner basically covers their own partner draws for the first quarter, leaving $542.5k of paid in capital. However, the profit diluting impact of these distributions still remains. Also, the cash to pay the expenses must be sourced from elsewhere in the firm, either from capital or debt. Using a five-year amortization period on $2,737,500 of expense, $547.5k in transaction expense is recognized in each of the first five years.

> Money is *not* fungible; it comes *from* somewhere and it goes *to* somewhere, and it matters.

This overstates income in the first year by $2.19 million when compared to a current expense treatment, and depresses income by $547.5k for the succeeding four years. This now covers the $797.5k of draws against profits in the first quarter for the lateral partners, and delivers $1,392,500 of higher reported "profits" for the partner pool. But there remains that not insignificant detail of where does the cash come from to pay the $2,737,500 in transaction expenses that are due now?

Here the problem of not matching cash flow with reporting of income and expense becomes acute. Beware that in some firms this is a use of the revolving line of credit or other debt. Money is *not* fungible; it comes *from* somewhere and it goes *to* somewhere, and it matters. If the cash comes from the bank, then higher distributions to partners may be maintained, but the firm will have to pay it back at a future date with earnings.

Her team is nominally expected to be delivering $450k annualized to the profit pool after stabilization of earnings, but the cost of bringing her aboard is $547.5k a year for five years, so stabilized the firm is negative to profit by $127.5k in years 2-5 and $210k negative in year one ($337k margin is collected if the start date is Jan. 1 because only nine months returns may be expected). The firm reports "growth" in gross revenues of $7.5 million the first year (RPP growth of $50k) and $10 million annually thereafter (RPP growth of $66.7k), but cumulatively net earnings are diminished over the five year period by $847k. Amortization of the capitalized "asset" of the costs of her addition over five years reduces the projected profit she brings in that period. Starting with year six, the $450k net contribution to the profit pool begins, taking almost two years more to pass the break-even point. She has "financed" her payment of the transaction costs with the projected margin contribution over a term of seven years.

The super star team covers their draw advances with capital, with a slightly smaller margin of $420k. Yearly amortization of transaction costs is $1.48 million and income in the first year is overstated by $7.62 million. The team is expected to deliver $4.6 million annualized to the profit pool after stabilization of earnings. But $1.8 million is redirected back to the three equity service partners, so that leaves an expected net $2.8 million. Less the amortization, that means $1.32 million in years 2-5 and $170k in year one.

Cross check the above for our star partner with six associates, with average levels of profit contribution and two income partners, at an estimated $250k profit contribution each, for roughly $1.3 to $1.6 million total. Observe that all of the contribution to the partnership profit pool from the associates and two salaried partners on her team really goes to support the profit needed to pay the star lateral the difference between what she earns herself, and what her guaranteed profit share is. The junior equity partner's compensation and the contribution to the profit pool all must come from him. That is slim profit from the model, and risky when more than half of lateral partner additions don't work out during the initial five years. The lock step advances of her salaried team members could squeeze the future achievable profit in an environment where costs are rising and rate increases struggle to keep pace.

Now do the same with our super star with 18 associates and six income partners. The margins are better because he is taking 16 percent of the gross revenue projected. It is just a simple matter of how much of a ratio he takes off the table, and the transaction cost load.

Does it make sense to hire her? If things work as planned, the firm is not going to net additional money for at least seven years. A shortfall in her performance will cause deep profit declines that are taken from other partners. Basically, she brings an already leveraged package, and pays herself from it. The "enterprise profit" from the new work is consumed, with little to nothing left to share with the new firm. If there is a guarantee, there is little risk to her if she underperforms, but real risk to the firm, depending on the guarantee terms. The financial burden of a star that promises $10 million and delivers $7 million is at least a $1 million decline in firm profit, assuming perfect response to reduced workload by cutting variable costs and allocable fixed costs, which cannot be done. The real decline in firm earnings is likely to be quite a bit higher. Even if she delivers the business as expected, after more than five years of no net contribution, the contribution to firm profits is only 4.5 percent of gross fee collections from her team. She is taking 27.5 percent of the projected revenue. The super star is taking 16 percent. The pressure for a star lateral partner to be successful is immense, indeed critical, for both the firm and the star. And there is that issue of repaying the debt incurred to cover the cash flow to pay the recruitment and pipeline expenses when no monies were coming in.

However, as we shall see in the next installment, the really hard obstacles have yet to be considered.

Edwin B. Reeser *is a business lawyer in Pasadena specializing in structuring, negotiating and documenting complex real estate and business transactions for international and domestic corporations and individuals. He has served on the executive committees and as an office managing partner of firms ranging from 25 to over 800 lawyers in size.*

ID: 2084703
size: 6.449 by 8.64
DAILY JOURNAL CORPORATION

Examining the real cost of purchasing lateral talent

This article is the fourth in a five part series examining the cost to a hypothetical law firm of lateral lawyer hiring.

The Star

Hiring a star lateral, an attorney with unquestioned skills, reputation, work ethic and good "citizenship," with $10 million annually in collections, or a super star with $30 million, presents immediate challenges that may be invisible unless openly disclosed and discussed by firm leadership. The partnership must draw cash from current earnings, capital additions, or debt to facilitate the addition of a star candidate, and recognize an immediate reduction in partnership profits, or defer into the future significant amortized expense that is a potential drag on future earnings. Forecasting cannot be exact, and unknowns may adversely impact the best possible due diligence. For management entrusted with the survival of the firm, that cannot be an excuse; recognizing and managing risk is what good management does.

FOURTH IN A FIVE PART SERIES

Part three appeared on June 20. The series is collected at www.dailyjournal.com.

Should a star leave within five years, and statistically half of them do, there is a burden from acceleration of the balance of that capitalized cost into current expense, depressing current earnings. Presumably the firm will collect on accounts receivable while being spared the variable expense of their salaried team, assuming they take them all, giving a short-term boost to profits. But much fixed overhead attributable to a group can't be cut immediately. The firm should pay return of capital while booking income from receivables. So "profits" may go up from collection of receivables, profits may go down from writing off the balance of the capitalized cost of their addition, and monies flow out to repay capital. The possible scope of mismatches in cash flows and income/expense recognition is in the many hundreds of thousands, perhaps millions of dollars, just as when they joined the firm. What was once done, eventually must be undone.

Revisit the hiring decision. Rather than capitalize cost components of hiring a team, fully expense them in the first year. Pipeline costs and recruiter fees in our star example were $2.737 million, and they reduce income by that amount. For the super star they were $9.1 million. For the star, is that an "investment" worth making for a $450k annual return? Every other partner in the firm takes a personal pay cut of about $18,250 to underwrite the star acquisition, for a $3,000 annual return. Does that sound too low? It might be defensible as an investment for a single opportunity acquisition, though not compelling. For the super star every partner drops $60,666, for a return of $18,666. But let's dig deeper into the strategy if it contemplates aggressive growth through multiple lateral additions.

What if the firm hires 10 "stars" in one year? The income reduction is $182.5K per partner! The current net return is $4.5 million to the firm and $30,000 per partner. Gross revenue is up $100 million, but partners take a pay cut. Can management justify that and get partnership approval? What happens after five consecutive years of aggressive lateral hiring? Against the risk that if even one star fails to deliver their promised book of business and performance, such as generating $7 million in fees rather than $10 million, the impact is at least $20,000 per partner reduction in income. If the star has a guaranteed contract, that could become a sensitive underperformance discussion. If five stars underperform, the impact is $100,000 profit reduction per partner. At some point over a five-year term, with half of such laterals failing to meet expectations and hiring 10 per year, that is the predictable outcome.

If all or most of the stars have guarantees, the allocation of reduced income is higher among the nonguaranteed compensation partners, most of whom are mid-level partners and already net contributors to the partnership profit pool. Compression on allocable incomes to the nonguaranteed partners quickly becomes unbearable, especially if management does not act swiftly against underperformers. Alas, with multiyear guarantees outstanding, that may not be possible. Preservation of profit to sustain the partnership must come from someplace. Most likely that source will be the grinders. The grinders receive a blatant pay cut, of material size, which goes into the "profit" pool. Pretext based reallocations of income among nonguaranteed compensation partners may occur, and all manner of other techniques to triage the problem created. So the bottom line here is that this is not structured satisfactorily to justify the risks and transaction costs.

For the super star, the acquisition is still pricey, but the payback is certainly faster. It might work. The answers lie in the relative transaction costs, and in the amount of the profits that the lateral retains. For our star partner, the pricing versus returns really just aren't there. For the super star partner, he is leaving more on the table for his partners. But in both scenarios, there is serious risk to the firm with an early departure because the transaction costs have not been returned through profits from the lateral.

This example illustrates but one problem of changing accounting methodologies to avoid having to confront head on the current cost of lateral partner hires, particularly in a less than transparent management style. What for a mid-level partner hire was a technique (described in Part Two of this series) that allows for a current addition that is relatively painless financially, when applied to star lateral partner hires can lead to countdown for a detonation if the pricing and transaction costs are not in balance.

> Being a partner in an enterprise whose stability and strength assure that a partner will be able to keep the money that they earn could have greater allure than just being part of an entity that is willing to pay more than another firm for their talent and business.

A firm that applies accounting techniques that mask recognition of the economic consequences of an aggressive hiring strategy, can potentially dig a large financial hole in a relatively short time. Exacerbated by rollover of unsuccessful lateral hires, liabilities accelerate. Imagine what happens when making twenty new lateral partner additions to net ten because the firm lost ten! It may look like management is actively handling the issue by removing "underperforming partners," but in fact the hole gets rapidly deeper with a cash flow squeeze, and the firm still has hundreds of thousands, indeed millions of dollars of unrecovered "pipeline" and recruiter costs.

If the firm balances cash flow squeeze by (a) collecting departing partner receivables while not returning departed partner capital (such as by adopting a deferred capital return payout scheme that stretches into years while departed partner receivables are collected over months); (b) borrowing money from banks or other sources (like packaging up all the furniture, art and equipment and leasing it back); or (c) manipulating internal profit allocations in a black box compensation system that only management and a few insider senior partners know and understand, one may readily see how quickly a massive, and yet to the partners at large still unrecognized, liability accrues to the firm and themselves. One day, and that day will come, with no more deflection/deferral tools remaining, the imbalance is discovered. The scope of the problem begins to be recognized, notwithstanding efforts to control or conceal it, confidence in firm leadership is lost, pricing of the repair is so great that collapse is a preferred outcome saving the firm, and the exodus of partners begins.

What "intangibles" make a "yes" hiring decision sensible beyond the numbers? None if what we are talking about are numbers. The "intangibles" are incorporated when establishing the numbers. Star led groups, with bargaining power to extract every penny of what they bring for themselves, bring nothing for the partners in their new firm and are a burden. Half a dozen successful star lateral additions are easily undone by one or two modest star failures.

When star lateral groups depart, surplus infrastructure remains with continuing cost. Managed incorrectly, stars park a "silo" practice within a partnership, pay modest amounts for using firm space and keep their practice income.

Any firm should, assuming she is a good citizen and willing to be a solid partner, be seriously interested in hiring a partner who produces gross revenues the way our example star and superstar candidates do. But the reality of the true costs and risks associated with this type of lateral partner candidate cannot be underestimated. There is a long-term investment, and serious risk associated with a move of this type, for both candidate and law firm. If she goes to a firm that does not properly account and provide for the cost of adding her, she may be inadvertently contributing to its demise, and will pay a terrible price herself with lost capital, possibly disgorgements of distributions as being constructively fraudulent distributions to an insider when the firm was insolvent, and "unfinished business" claw-forwards for ongoing cases taken to yet another firm.

Correct pricing for the lateral is critical, and adjusting a few assumptions can turn the star into a winner, and the super star into a loser for the firm in the above examples. Will Rogers famously commented that he was considerably more concerned about the return *of* his money than the return *on* his money. Being a partner in an enterprise whose stability and strength assure that a partner will be able to keep the money that they earn could have greater allure than just being part of an entity that is willing to pay more than another firm for their talent and business.

Will changing assumptions impact our evaluation? It depends on which ones, and if you change them a lot. Assume the star bills and collects an additional 200 hours on her own time. That adds perhaps $160k to her revenue stream. All other factors remaining the same, that probably isn't enough to change anyone's answer. But reduce her compensation by $750k and it probably does. Similarly, cut the hours on our super star by 200 and it has some impact, but probably not enough to change the conclusion. But increase his compensation by a million dollars, and it probably breaks the stick. Do customized margin studies on the portable book to accurately frame proper compensation? A 30 million dollar book of lower rate insurance defense litigation is not going to be worth the same as a 30 million dollar book of high rate securities litigation, because the allocations of overhead and the profit margins on both will be very different.

The senior associate and contract partner grinders and mid-level partners are each contributing a few hundred thousand dollars to the enterprise profit of the operation. And certainly some of the successful stars can contribute even more. It might be worth considering whether star partners should be compensated at a level where they do the same. Then adopt a program where the aggregate of such profit is dispersed back to *all* of the partners in accord with a formula deemed equitable by the partners and to the partners. Once the enterprise profit allocations effectively all go to a privileged few, there may not be a real partnership.

So one answer to this question is "maybe it makes sense to hire stars, and super stars, but a lot less often than one might think."

You might want to consider hiring 10 mid-level additions, and no stars, and everybody makes more money. Or reconsider how much the firm can really afford to pay for stars and reset the pricing. Some of the best deals you don't make could be for star talent that goes to another firm.

In the next installment, we will take a look at how the associates fit into the picture of the law firm that is hiring with the intent of making a sustainable profit.

Edwin B. Reeser *is a business lawyer in Pasadena specializing in structuring, negotiating and documenting complex real estate and business transactions for international and domestic corporations and individuals. He has served on the executive committees and as an office managing partner of firms ranging from 25 to over 800 lawyers in size.*

ID: 2084730
size: 6.449 by 864
DAILY JOURNAL CORPORATION

Extraodinary compensation, declining prospects

By Michael H. Trotter

Chapter Three

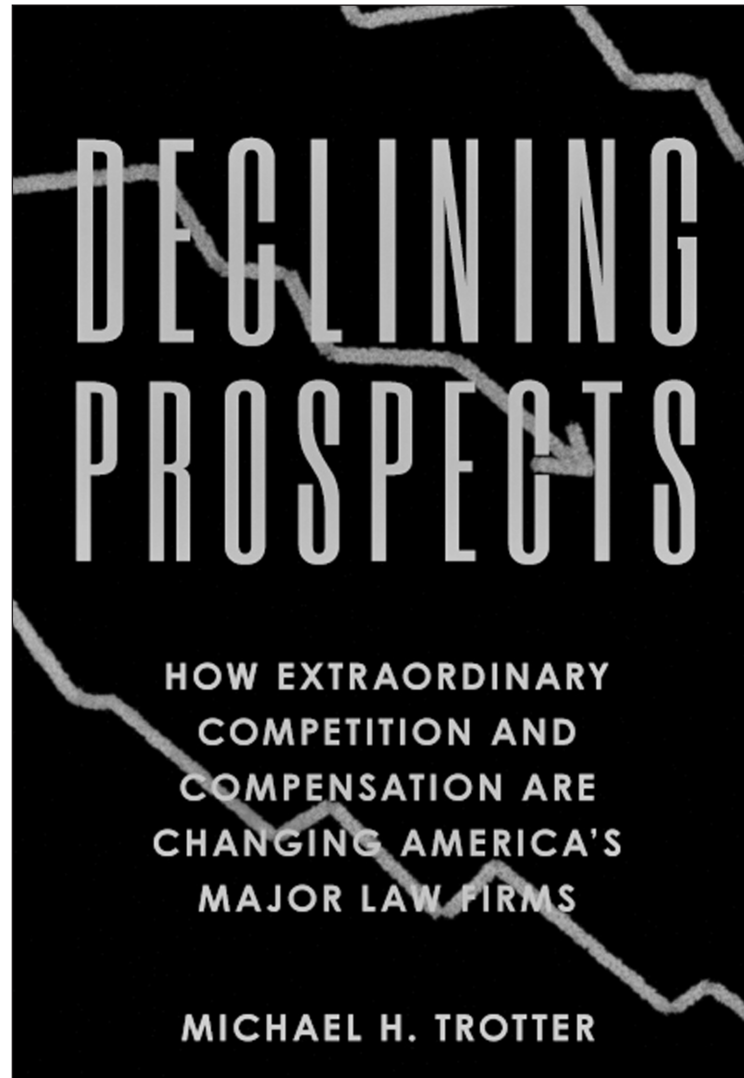
Why Working Conditions Have Declined

As the major business practice firms became more profitable to their lawyers, working conditions for the lawyers declined. In May of 2005 I participated in the first session of the Raise the Bar colloquium on working conditions in the legal profession sponsored by the Litigation Section of the American Bar Association. The subtitle of the colloquium was A Project of the ABA Section of Litigation to Reclaim the Soul and Redefine the Bottom Line of the Legal Profession.

BOOK EXCERPT

The colloquium had been assembled because the leadership of the Litigation Section thought that the lawyer morale problem had become serious and deserved thoughtful consideration at the top level of the profession. Brad Brian, a Munger Tolles partner and Chair-Elect of the Section, was determined to make the Raise the Bar project the signature initiative of his year as Chair. The program was co-chaired by Yuri Mikulka, a Howrey partner from Irvine, and Lawrence Fox, a Drinker, Biddle & Reath partner from Philadelphia and an Adjunct Professor at Yale University Law School. Mr. Fox had served as chair of the ABA Standing Committee on Ethics and Professional Responsibility and was the 2007 recipient of the Michael Franck Professional Responsibility Award of the Association. The initial 75 participants were a diverse group of private practice lawyers, corporate counsel, corporate executives, academics, and consultants. A few associates of private practice firms were included.

The body of the law has grown to such an extent that it is no longer possible for even the brightest and hardest working lawyer to keep current with more than a small part of it.



The project evolved into a year-long examination of working conditions in U.S. law firms with a view toward finding ways to improve them. The Raise the Bar colloquium discovered during the year following the initial meeting that:

First, lawyers at every level complained ... about the transformation of the legal practice from a profession to a business. While per partner profit statistics indicated that lawyers have reaped large financial rewards from this transformation, those rewards have come at a price: more hours, less loyalty, increased tension among colleagues, reduced time for pro bono work and public service, and greater disruption of family and personal lives.

Second, lawyers across the spectrum complained about the reduction in hands-on experiences. Increasing complexity of cases and transactions mean that more lawyers spend more time as parts of teams gathering and sorting information-and less time with clients or in court, arguing motions or trying cases...

Whatever the cause, lawyers are leaving the profession in droves. Others remain in the profession, but are unhappy with their careers and in some cases their lives. (1)

What is to be made of this undercurrent of deep and abiding dissatisfaction among lawyers with the practice of law? I believe that the growth in size of the major law firms in the United States and their increased utilization of leverage are two of the most significant changes that have negatively affected working conditions in the private practice bar. As a result of huge increases in size and leverage the working environment and relationships in most major firms changed significantly, and over time the personal dynamics of these firms bore less and less resemblance to what they had been when many lawyers currently in practice began their careers. I believe that these changes have reduced the quality and increased the cost of legal services to clients.

Other factors contributing to the law practice malaise include increased competition for legal work (and the insecurity that results from such competition), outside counsel's loss of control over the legal work performed for corporate counsel, increasing demands for systematic and standardized solutions to legal problems, increased specialization, and the burden of 24/7 commitments to the practice of law as a result of the communication-technology revolution. The body of the law has grown to such an extent that it is no longer possible for even the brightest and hardest working lawyer to keep current with more than a small part of it.

Most of these contributing factors are outside the control of private practice law firms. However decisions about size and leverage are largely within their control. The decision by many major firms to become very large and highly leveraged has had a profoundly negative effect on the firms and on the personal experiences of their lawyers.

Not so long ago throughout the United States most of the largest business practice law firms were very small in comparison to today's firms, and most had fewer associates than partners. Indeed, the largest firm in 1960 was smaller than the smallest firm on the 2009 Am Law 200. (2) The small and amiable professional partnerships of mid-20th century America have become very large and generally impersonal business organizations in the early years of the 21st century.

(1) Brad D. Brian, Foreword, RAISE THE BAR: REAL WORLD SOLUTIONS FOR A TROUBLED PROFESSION, at vii-viii (ABA 2007).

(2) In 1960 the largest law firm in America was Shearman, Sterling, & Wright which had 125 lawyers. The smallest law firm on the Am Law 200 in 2009 was Morris, Manning and Martin which had 137 lawyers and $83 million in gross revenue. Gross Revenue Takes A Fall: 2009 Gross Revenue, AM. LAW., June 2010, at 95-100; MICHAEL H. TROTTER, PROFIT AND THE PRACTICE OF LAW: WHAT'S HAPPENED TO THE LEGAL PROFESSION 1 (1997).

Excerpt from "Declining Prospects: How Extraordinary Competition and Compensation are Changing America's Major Law Firms," by Michael H. Trotter. Reprinted with permission.

Michael H. Trotter *has served as the primary securities lawyer for more than 15 public companies, devoted a significant portion of his practice to closely-held and family businesses, and taught courses at Emory University Law School. The 1997 precursor to his latest book was titled, "Profit and the Practice of Law — What's Happened to the Legal Profession." Trotter can be found online at the law firm of www.taylorenglish.com.*

Examining the real cost of purchasing lateral talent

By Edwin Reeser

This article is the fifth in a five part series examining the cost to a hypothetical law firm of lateral lawyer hiring.

The four prior installments of this series looked at the contribution to profits derived from the labor and business delivered by grinders, mid-level and star partners to their law firms.

Where are the associates in the lateral hire pricing model?

When we look at the associate hiring decision for the attorney with five years or less experience, the hiring decision is quite different. Primarily this is due to attrition rates and the attendant cost, and billing adjustments.

An associate at $350 per hour and 2,000 billable hours is producing $700k recorded time. After average adjustments to pre-bills and realization they generate about $600k in collections, well below the $800k RPL average of our example firm. Subtract $140k for overhead, another $230k for salary and benefits, and the total contribution to profit is $230k. Note that is the average, it doesn't work that way overall in most firms. Write offs for associates in the initial two years are more likely in the range of 20 percent or more. Some clients won't pay for first or second year associates. Pro bono work is pushed to junior ranks and credited as "billable." It is good experience and should be counted, but for the narrow purpose of cash flows and profits, small direct benefit.

LAST IN A FIVE PART SERIES

Part four appeared on June 20. The series is collected at www.dailyjournal.com.

Most firms typically "invest" $25 to 50K per year on each junior associate each year. That doesn't include training programs, summer clerkships and allocation of recruitment costs. Associates have nothing to be defensive about with respect to this evaluation of limited profit generation.

Thirty-six years ago as a junior associate with a large firm I was scared to death that while working my tail off, I had little idea of what was going on, could be terminated instantly for an offense as minor as having less than perfectly shined shoes, and couldn't believe the position warranted the then lofty Wall Street salary of $18,000. My senior associate mentor laughed when this concern was confided to him, and commented "Don't worry, they already know. Take the money." The prospect of making partner then was perhaps one in 10, after nine to 10 years. Clearly, a component of compensation, besides competition to obtain the best law graduates, is a hazardous duty premium.

The tipping point on current profitability for associates in most large law firms is partially through or by the end of the third year. At that point the firm "investment" is about at its end from an out-of-pocket expense perspective. Break-even, the point at which the monies invested have been recouped is often a couple of years later, perhaps the end of the fifth year. This varies with firms and their programs, but is reasonably accurate for most practices.

The number of associates with seniority of four to eight years is far fewer than the number of associates with zero to three years. Profit margins climb sharply with seniority, and returns on senior associates are very profitable. A more senior associate with billing rate of $400 per hour and 2,000 billable hours generates $250k-300k profits, comparable to income partners. Given the flogging associates receive to bill hours, it seems incredible that as a class associates don't generate more profit. But the business model applied by law firms causes approximately 20 percent associate attrition per year. Too many associates don't last long enough to overcome the firm's sunk cost.

Can associates be made more profitable in their junior years? The short answer is "yes," but as presently approached it comes with a price. One method is to increase the billed hours expectations upward, and to do it significantly. If the requirement becomes 2,400 hours, even with substantial write downs there can be net profits extracted.

A second method is to apply the associates to work that requires little training and modest supervision so that the write downs are modest. Unfortunately this means that the work performed has limited learning value and compromises the future value of the associate as an attorney, whose skill sets do not improve sufficiently to warrant promotion.

A third method is to apply billing rates that are high relative to the value delivered to the client for the service performed. Armies of over-qualified, overworked and overcharged associates working on document review is one example of all three in action. These techniques, applied singly or in combination can deliver a boost to revenues for firms that apply them, but at a longer term and terrible cost to the associate, to the client, and ultimately to the firm.

The sustainability of the model is under attack from low cost alternative service providers, outsourcing, expanding in-house capability, and client resistance to high rates. With the aforementioned attrition rates, there is significant built in cost to the firm that tends not to be recognized, though in the world of business it would be meticulously tracked.

The current wasteful model of grinding through talent will have to be reformed into one that develops quality lawyers who are profitable sooner to the law firm.

Reportedly there are twice as many law school graduates as meaningful positions available, and serious pressure on law firms to hire still fewer of them. The cost of a legal education relative to reward is under attack as well. But firms need to have third year or fourth year associates, and they won't be around unless they are hired and trained well someplace. The current wasteful model of grinding through talent will have to be reformed into one that develops quality lawyers who are profitable sooner to the law firm. They have to deliver value to the clients from their own work, not just profit to the partnership. The present model is a major drag on efficiency and profitability in most large firms, and often a bitterly unhappy work environment.

Everybody is looking for something

This series highlights that in many law firms, with a neutral to negative contribution to profits taken from the body of the associate class as a whole, the leverage that delivers the highest levels of sustainable profits comes from more senior levels. Firms actively deprive themselves of a home grown supply of the best and the brightest, wasting the most precious asset they need: future talent. While some firms increase profits from the current model of associate leverage, many firms earn little or no profit from it.

Net contributors to the partnership profit pool in many law firms are senior associate and income partner grinders. It is probably of little surprise that junior equity "service" partners are also net contributors. It is perhaps of considerable surprise to many mid-level equity partners, including those with multi-million dollar books of business, that they too are net contributors. This introduces a potentially destabilizing force, the dawning realization for many mid-level partners that they will best be served leaving law firms that apply this compensation model for a firm that doesn't.

This series demonstrates some basic variables to consider in lateral hiring so that firms can make well informed and reasoned decisions about hires that will support the stability and financial prospects for sustained success, and avoid poor approaches for perceived short term advantages that can injure, or possibly destroy, an otherwise healthy firm.

There are many additional considerations in a careful evaluation of lateral hiring and the setting of compensation. A few firms of late have got it wrong. The bigger concern is not who has got it right, but who has got it not quite right enough that they might not survive unless adjustments are made.

Let's take one simple example. If a partner delivers 10 million dollars in revenues with 10 lawyers, at high billing rates, low pre-bill write downs, high realization percentages, rapid turnover of 35 days from billing to collection, should that partner receive the same compensation as one who delivers 10 million dollars in revenues with 15 lawyers, at low billing rates, high pre-bill write downs, lower realization percentages, and slow turnover of 75 days from billing to collection? Cumulative variable costs of attorneys, paralegals and staff, and allocation of fixed overhead costs for the larger group will deliver a smaller net profit for the partnership.

When does "10 million dollars" not mean 10 million dollars to the law firm? When gross margins to the profit pool are materially different. Gross revenues are important, but it is net profits that are distributed to partners. Relative contribution to distributable profits is not difficult to analyze for a lateral, nor to existing partners. It has been difficult to apply in setting compensation among existing partners in law firms, notwithstanding its obvious fairness. This analysis can show that some partners, or groups, are consistently overpaid for their contributions to the firm profit pool. Unfortunately, in some circumstances, in some firms, compensation has less to do with fairness and more to do with other components of law firm operation, history and governance.

These are not necessarily a "bad" thing in all circumstances. Lock step compensation or more narrowly banded compensation spreads, such as five to one from highest to lowest partner, if they are subscribed to by the partners as "fair," can surmount otherwise contentious issues. Lockstep comes with its own price, but its continued use and success should be noted. The "eat what you kill" system can also command strong support, but typically requires more attention to being fair and consistent in measurement of performance and allocation of rewards, or else confidence will be lost in the system. Wide compensation spreads are not out of the question, they just have to be properly matched to real contribution to the profit pool of the firm or they can become a burden and destabilizing to the structure of the firm. The cloak of concealment over any system only adds to the challenge. The application of good tools to a bad purpose, such as in accounting treatments to hide the true financial condition of the firm, especially from the partners, should never be considered acceptable.

The approaches presented in this five part series are summary and not exhaustive. They are one means of establishing a simple, straightforward introduction to the calculation of contributions from differing types of lawyers to a law firm when considering a lateral hire. They are eligible for further refinements to better fit a specific law firm, which are too numerous to address in a general article. Get started thinking about what is really happening in your firm, so you can confirm the correctness of your firm's current course, or get out the rudder and help steer your firm to a better course than where it is pointed now, or debark before you reach the shoals.

Edwin B. Reeser *is a business lawyer in Pasadena specializing in structuring, negotiating and documenting complex real estate and business transactions for international and domestic corporations and individuals. He has served on the executive committees and as an office managing partner of firms ranging from 25 to over 800 lawyers in size.*

SUBMIT A COLUMN

The Daily Journal accepts opinion pieces, practice pieces, book reviews and excerpts and personal essays. These articles typically should run about 1,000 words but can run longer if the content warrants it. For guidelines, e-mail legal editor Ben Armistead at ben_armistead@dailyjournal.com.

WRITE TO US

The Daily Journal welcomes your feedback on news articles, commentaries and other issues. Please submit letters to the editor by e-mail to sharon_liang@dailyjournal.com. Letters should be no more than 500 words and, if referencing a particular article, should include the date of the article and its headline. Letters may not reference a previous letter to the editor.

ID: 1958612 size: 2.07 by 2.78, Daily Journal standa