

Profits Per Me (PPM)

By Mark Jungers and Jane Sullivan Roberts

Over the last 20 years, *The American Lawyer's* profits per partner (PPP) has become the number America's largest law firms use to keep score. Perhaps more importantly, it is the number lateral partner candidates use to evaluate the strength of a firm and to predict their compensation. While law firm partners generally assume that a higher PPP will result in higher compensation for them, PPP is a surprisingly poor predictor of an individual partner's compensation. PPP is just a measure of the average compensation of the firm's equity partners. As one of our firm's founding partners, Jon Lindsey says, lateral partner candidates need to look beyond PPP and focus on what he calls PPM — "profits per me." Averages are great, but how much of the law firm's profits can I fairly expect to get?

We have seen situations where the market compensation for an individual at one set of firms is roughly \$500,000 and at another set of firms in the same city is double that for a guaranteed period of time. The difference lies not in the firms' respective PPPs, but rather in the various structural, cultural and historical factors that influence their ability and willingness to pay premium compensation and bonuses, guarantee base compensation, and take creative approaches to attracting talent.

A HYPOTHETICAL SITUATION

To help illustrate the factors that typically contribute to PPM, consider the following hypothetical: Jennifer is a third-year intellectual property partner practicing at an IP boutique firm with an estimated portable practice of \$5 million/year. She has exceptional credentials

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with a Ph.D. in Molecular Biology from MIT and a law degree from Yale, and generally bills 2,200/hours a year at \$525/hour. She has been a partner for the last three years and has seen her practice double each year since becoming a partner. The majority of her practice comes from a close friend who started a biotechnology company. She is most interested in a large general-practice firm so she can more broadly serve her rapidly growing client as it looks toward a possible IPO.

Economic Contribution

Most law firms have compensation systems that factor in intangible contributions such as firm citizenship and management, as well as economic contributions, as measured by business generation (originations/collections), billable hours, and billable rates. For lateral partners whose firm citizenship and management skills are less apparent to the new firm, firms have over the last ten years increasingly focused at least initially on business generation and billable rates. Firms typically ask a lateral candidate to provide an historical account of his economic contribution over the prior three or even five years and to estimate how much of that business is likely to move to the new firm. Not surprisingly, a lateral candidate with a history of higher economic contributions and a large amount of portable business will generally be paid more than one with lower economic contributions or a smaller amount of portable business.

Turning to Jennifer, she knows from speaking with her recruiter and friends at other firms that compensation for a \$5 million practice ranges from the \$1 million she is paid to, in some cases, nearly \$2 million. Jennifer's originations, hours, realization rate and billable rate are strong. Other factors probably explain her relatively low compensation.

Strategic Need

The ideal lateral partner both brings a book of business and fills a strategic need such as providing a specific skill set, lifting the firm's profile, adding critical mass, or opening doors to new relationships. While firms occasionally hire lateral partners who bring only a book of business, they prefer,

and will pay more to, one who also fills a strategic need.

On the flip side, firms sometimes hire a lateral partner with little or no business but who fills a strategic need. For example, firms often see hiring a marquee lateral such as a high-profile government lawyer from the Solicitor General's Office, the Antitrust Division of the Department of Justice, or the Security and Exchange Commission as a way for them to enter or bolster a practice area with instant credibility. These firms typically place a higher value on such lateral candidates and are willing to pay a significant premium over firms that already have well established practices in the area.

So, returning to Jennifer, one reason for her relatively low compensation is that she may not fill a strategic need at her firm. The boutique may have several partners with a strong biotechnology background, and probably cannot take full advantage of the business opportunities outside IP. A firm with an IP practice with a need for a molecular biologist may pay Jennifer more. Similarly, a firm with the experience and capabilities to take biotechnology companies public would also likely be more interested in Jennifer, and pay her more.

Hot Practice Areas and the Market

A "hot" practice area is one in which the demand for talent exceeds the supply. Looking back at 2007, for example, hot practice areas included private equity, corporate, real estate finance, and securitization. Firms typically found themselves competing vigorously with other firms to attract talent in these areas. That competition often drove firms to pay these lateral partners a premium, that is, more than what they were earning at their old firms and more than what the new firm would pay a legacy partner for an equivalent economic contribution.

Jennifer's candidacy further illustrates how market forces can impact compensation. Biotechnology is a perpetually hot practice area because the supply of highly skilled lawyers — those with medical and doctoral degrees — is minuscule compared to the demand. Firms that need Jennifer's expertise are more likely to pay her a premium over what they pay other lawyers for a similar amount of business.

Premium compensation, however, does have its pitfalls. At some point after joining the new firm the lateral partner's economic contribution will have to match up with his compensation. And, the higher the compensation, the faster the firm will expect the lateral to ratchet up his economic contribution to match his similarly compensated peers.

Structural, Cultural, and Historical Factors

A firm's ability or willingness to pay premium compensation to lateral partners may depend on certain structural, cultural, or historical factors at work in the firm.

Compensation Spread/Ratio

The spread or ratio in compensation between the highest and lowest compensated partners can be an important factor in determining partner compensation. At one end, several "elite" firms at the top of the AmLaw 100 list have ratios as compressed as 3:1 or 4:1 from the highest to the lowest compensated partner. These firms rarely hire lateral partners, in part for reasons of culture, tradition and lack of necessity, and in part because competitive compensation for star laterals is less likely to fit well into the firm's spread. "Aspirational" firms (those seeking to move up on the AmLaw 100 rankings) have wider spreads/ratios: 10:1, 15:1 and even 20:1, giving them more flexibility to compete for top talent. Thus an aspirational firm with a lower PPP but higher spread than an elite firm can often pay more for top talent.

Looking at Jennifer, she has a thriving practice; while above the average for equity partners at most AmLaw 100 firms, it is not large enough to stretch the top of an AmLaw 100 firm's compensation system.

Open or Closed Compensation Systems

Many partners don't like to see someone with an economic contribution equivalent to their own paid a premium over what they are paid unless there is a very good reason for doing so. Thus firms with an open compensation system (where each partner's compensation is disclosed to all partners) sometimes have less flexibility to pay a premium than firms with a closed compensation system (where that data is known by only a handful of partners and administrators). Firms with open compensation systems need to manage carefully communications to the broader partnership about the lateral's premium compensation, making the business case for the need, the benefit and the market forces that justify it.

For someone like Jennifer, how she fits into the strategic plan of the prospective firm and how that fit is conveyed to the general partnership, to the partners in her practice group, and even to specific partners at or near her compensation and/or business generation

level will be important factors when the firm determines her compensation.

Bonuses

Most firms award their partners bonuses based on firm profitability (firm exceeds budget) and individual performance (outstanding contributions). More and more firms are also budgeting for lateral partner signing bonuses to entice lateral partners to the firm. Some bonuses are meant to make whole lateral partners who will forfeit some compensation upon leaving their old firm, while some are designed purely to entice a lateral to the new firm. Signing bonuses are particularly attractive to government attorneys after years of public service. One-time signing bonuses can also be more palatable to legacy partners than premium base compensation, which can be hard to adjust in subsequent compensation cycles. Some firms structure signing bonuses as forgivable loans, with a portion forgiven on the candidate's first anniversary and the balance periodically as other milestone dates are reached.

Compensation Cycle and Guarantees

Firms typically guarantee a lateral partner's base compensation for some period of time. The vast majority of AmLaw 100 firms have a one-year compensation cycle with a small number of firms setting partner compensation every two years. Even in cases where the lateral has a large practice that transitions to the new firm, it is at least two to three months before the firm receives its first dollar from the lateral's business. As a result, firms typically guarantee compensation for the remainder of the lateral's first year (the "stub"). Some firms, if it does not contravene their "we're all in this together, you take your points at whatever value they turn out to have next year" philosophy, may guarantee the stub plus one additional year or (in a recent trend for high-profile laterals) the stub plus two or even three years.

Budget Cycle

Near the end of a budget cycle (usually calendar year end) many firms, even those with significant budgets for lateral partner acquisitions, find limited financial flexibility to pay premium compensation or bonuses. In these situations, the firms may put off the acquisition to the next budget cycle or next year, or find a creative longer term solution that does not impact the firm's immediate financial picture.

Seniority

In some firms, particularly those in traditionally less competitive markets, seniority still plays a significant role in determining compensation. In certain areas of the South and Texas, for example, local firms have been unwilling to pay laterals, even star perform-

ers, materially more than what their classmates are paid. New law firms entering these markets have seen the opportunity and, for top talent, are paying premium base compensation and signing bonuses. For someone like Jennifer whose practice is booming at a relatively young age, a compensation system with a heavy seniority component would likely depress her compensation.

Decision-Making Process and Prior Success with Laterals

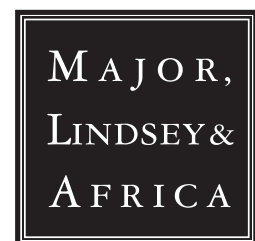
We have observed that firms who entrust their lateral partner hiring decisions to a small circle of partners are typically able not only to move faster in recruiting lateral partner talent, but also to be more flexible in fashioning a competitive compensation package. Many of these firms have made big bets on lateral partners; whether they are inclined to make additional big bets is likely to depend on the success of the earlier wagers.

CONCLUSION

Any partner considering moving to another firm should be open to speaking with firms in a wide range of PPP. Put another way, it can be a grave mistake to assume that because a firm's average partner compensation is lower the firm cannot afford to pay them at or above their market value. Because any given partner's PPM — Profits Per Me — can vary significantly from firm to firm due to a combination of market and firm specific factors, a potential lateral should focus first on whether a firm provides the strongest possible platform, and whether the firm's culture is a congenial one, before focusing on short term compensation.



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