



Of Partners and Peacocks

To understand why the lateral market has gone so wrong, look to the animal kingdom.

By William Henderson and Christopher Zorn

IN THE FIELD OF EVOLUTIONARY biology, a phenomenon known as Fisher's runaway provides an interesting nuance to the theory of natural selection. Under natural selection, females of a species are typically drawn to males who offer their offspring the best chance of survival. Yet, in cases of a Fisher's runaway (also known as runaway selection), the attributes that make the male more attractive for mating can, over time, reduce the survival prospects for the species as a whole.

The classic example of a Fisher's runaway is the peacock. Although the female peahen is attracted to the peacock's large, colorful tail, the tail itself offers no advantage for survival. In fact, the opposite is true: The bright colors attract the attention of predators, and the cumbersome size reduces the potential for a successful escape. Thus, to mate on the basis of large, colorful tails is to bring potential ruination to the entire species.

When it comes to the market for lateral partners, it seems a dynamic similar to a Fisher's runaway has taken hold among large U.S. law firms. We've spent hundreds of hours assembling and analyzing data about the lateral market and have yet to find a coherent story in which lateral hiring is, on balance, making most large law firms better off in the long term. Instead, we think a more likely scenario is one analogous to the peacock's tail, where an attraction to what is flashy and attention-grabbing may prove valuable (or, at least, not detrimental) during the peacock's own natural life, but not for those who follow. For the peacock, that is fine. But we suspect that most lawyers would aspire to something more.

If a law firm wants to break out of a Fisher's runaway, it is necessary to understand the market dynamics of lateral partner-law firm mating and the thought processes that cause firms to engage in hiring practices that are not strengthening the firm in the long



term. Stated another way, we need to better understand the peculiar environmental stressors of the U.S. corporate bar circa 2014 that are causing so much behavior that seems to help only in the short term. The problem is primarily ecological—the options available to law firm leaders are pretty uniformly bad. Yet, we think it is possible for some law firms, with the benefit of some clever, farsighted leadership, to move in a more sustainable direction.

For the last 13 years, *The American Lawyer* has been collecting data on partner-level lawyers as they move from firm to firm, or to and from government and in-house positions. The market for lateral partners is a brisk one. Since 2000, the volume has varied between 1,900 and 3,500 lateral moves annually, with the volume peaking during the frothy days of 2007 and 2008.

All of this movement is akin to a stock market, in which part-

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ner movement reveals information on the marketing standing of law firms, practice areas and geography. By matching the attributes of the firm left with the firm joined, we are able to measure the volume of lateral movement upstream or downstream (defined by firm revenues, revenues per lawyer or profits per partner) and to ascertain how this directionality has changed over time (and it has). Further, on the basis of the practice group joined, we can assign each lateral partner a practice specialty. We also track the geography of each move, based on the metropoli-

ated with higher profits, we would expect to see a trend in lateral movement associated with financial gains in the short to medium term (for example, one, two or three years later).

Last year, using an arsenal of multivariate statistical methods, we were unable to find a relationship between a lateral partner hiring strategy and higher law firm profitability [“Playing Not to Lose,” February 2013]. These results don’t rule out the possibility that some firms have increased firm profits through aggressive lateral partner hiring. Rather, the data is telling us that

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tan area of the office left and office joined, as lawyers (like all workers) are part of regional labor markets.

From studying 13 years of lateral movement, we have learned a few baseline facts:

Lateral hiring has become more common throughout the large law market. Since 2000, when ALM first began collecting lateral data, the proportion of The Am Law 200 affected by lateral partner movement in or out of the firm in a given year has increased from 70 percent to nearly 90 percent.

There is a practice premium (or discount) that applies to a lawyer’s area of practice. Lawyers in close proximity to the C-suite (that is, those specializing in white-collar crime, securities enforcement, private equity and M&A) tend to move into higher RPL firms. There are also practices—labor and employment, regulatory compliance and trust and estates, for example—where the landing places are typically further down the RPL food chain.

In the early 2000s, lateral partner movement resembled a farm system—that is, most movement was from smaller firms, often outside The Am Law 200, to larger firms. More recently the market has become more akin to baseball free agency, with partners moving between similarly profitable firms.

Things are changing at the top, as outflow from firms with the highest RPL is up threefold over the last 13 years. To return to the sports metaphor, more partners at top firms are being put on the waiver list and thus are free to be claimed by rival teams.

Overwhelmingly, lateral movement is local. In well over 90 percent of the cases, the lawyer changes his or her work address, not home address. This may be relevant to the next point.

Partner “churn” is greatest at large, geographically dispersed law firms—sometimes approaching 10 percent of the partnership in a given year—possibly because it is difficult to find partners who have a client base that both needs and can afford the rates of a global law firm. The higher overhead makes it difficult to have a mix of clients with primarily local versus primarily international needs.

At the same time, churn is the lowest at the nation’s most profitable firms—there is an average of roughly 1 percent partnership turnover among the nation’s 20 most profitable firms.

Moving beyond these baseline facts—what we academics call “descriptive statistics”—we sought to test a fairly simple hypothesis: Do firms that engage in more lateral partner hiring become more profitable over time?

This seems like a reasonable question to ask. Higher profits would enable firms to pay more to retain and attract top talent. If a strategy based on more aggressive lateral hiring is associ-

ated with higher profits, we would expect to see a trend in lateral movement associated with financial gains in the short to medium term (for example, one, two or three years later).

Perhaps this is telling law firm leaders what they already know. A 2012 ALM–LexisNexis Survey reported that only 28 percent of managing partners reported that lateral hiring was “highly effective,” defined as “most laterals have been retained and contributed to business growth.” Yet, in the same survey, 96 percent of managing partners reported that more lateral partners would be part of their firm’s growth strategy for the next two years, edging out business development (94 percent), pricing strategies such as AFAs (72 percent), lawyer development (71 percent) and client relationship management (65 percent).

This brings us back to the peacock. As a statistical matter, lateral partner hiring does not reliably improve a law firm’s relative profitability. Among the 20 Am Law 200 firms most active in the lateral market, the odds of them having above-average growth in profits per partner one, two or three years later is slightly worse than a coin toss. By managing partners’ own admissions, lateral partner hiring has not been a particularly reliable method for growing their firms. According to the Cravath, Swaine & Moore firm history, published in 1948, Paul Cravath assiduously avoided lateral hiring because he did not want the firm’s young associates and partners “subjected to the discouragement of seeing someone come in over them from the outside.” More recently, in his widely read article “The Death of Biglaw,” the late Larry Ribstein, a renowned expert on partnership law, corporate law and the legal profession, warned that “lateral hiring and geographic dispersion complicate firms’ ability to maintain a strong culture of trust and cooperation.” Yet, against this backdrop of logic and experience, 96 percent of law firms included more lateral partner hiring in their strategic plans.

Here is a good question—why? Just like the peahen is drawn to the peacock’s large, colorful tail, we suspect there is an economic logic for why law firms continue to be drawn into the lateral market, albeit a logic that doesn’t necessarily lead to economically or socially desirable outcomes.

The 2012 managing partner survey provides important clues. When asked about their firms’ top priorities, the most common answer (given by two-thirds of managing partners) was “growing the firm’s revenue.” Similarly, when asked about the key metrics for managing firm performance, the top pick was firm revenues, the answer given by over half of the managing partners surveyed.

Now, if a firm is attempting to increase revenues, there is ample statistical evidence that the lateral partner hiring strat-

egy can deliver. Law firms that have most aggressively pursued lateral hiring have also, on balance, experienced above-average growth in gross revenues.

Last year we suggested that law firm leaders might be attracted to a lateral partner hiring model because the larger resulting revenue base makes the firm (and them) less vulnerable to the departure of heavy-hitter partners. The logic is straightforward: A defection of 20 partners from a 200-lawyer firm has a proportionally greater effect than a 20-partner exodus from a 500- or 700-lawyer firm. Since it is difficult to orchestrate a coordinated defection of a large number of partners, larger firms are less susceptible to a Heller-Howrey-Dewey style run on the bank.

But we think there is another reason that law firms are drawn to the lateral partner market, one that is even more pragmatic. Decades of relentless growth have conditioned law firm partners to associate growth with vitality and dynamism, often through large incoming classes of associates. In the absence of organic growth, incoming lateral partners provide evidence that the firm is still vital and attractive. Indeed, one managing partner of an Am Law 100 firm confided in us that pressure to hire lateral partners springs largely from the partnership, not management. “Just like sorority and fraternity rush at college,” the MP told us, “being selected by a lateral candidate provides a sense validation that we are desirable. Unfortunately, too many lawyers never outgrow the insecurities of youth.”

Several law firm leaders have also told us that most laterals fall well short of their projected “realistic” revenue goals. Yet, engaging in lateral partner hiring helps persuade partners and practice group leaders, particularly those sponsoring a lateral candidate they perceive to be desirable, that the firm is “doing something” vis-à-vis peer firms. The only consolation is that the hit-rate for hiring successful lateral partners is low throughout the industry, so firms that do it badly can still maintain their relative position. It is a strange dynamic.

From the outside looking in, it seems obvious to us that the higher end of the legal services market (roughly the market served by the NLJ 250 and Am Law 200) is locked in a fight over market share. Revenues in the industry have been flat for several years, and there is substantial evidence that much of the work that was formerly done by junior lawyers has migrated to legal process outsourcers. Senior-level work is also increasingly shopped to lower-priced regional firm firms. Further, competition is coming from in-house legal departments that are building internal capacity to handle a large tranche of work they are trying to standardize. Regarding changes in in-house legal staffing, there is credible evidence that companies like Axiom Law are working with general counsel in the Fortune 100 to help redesign and streamline their in-house operations, enabling them to drive down risk and cost simultaneously.

It is useful to think of the current state of the legal services industry as akin to the Galápagos Islands at the time of Charles Darwin’s landing—the physical separation from the mainland enabled the island to evolve its own unique and peculiar ecology. Indeed, for decades the nation’s leading law firms have operated on entirely different economic principles than the rest of the U.S. economy. Specifically, many highly profitable law firms (a) have no long-term strategy that differentiates them from the competition, (b) make no significant investment in the selection and development of their principal product—human capital, (c) require little to no operating capital, and (d) rarely rely on data to make either operational or strategic decisions. Yet, instead of becoming extinct like their mainland counterparts, law firm

partners instead became millionaires.

The separation from the economic mainland is traceable to early 20th-century ethics rules [Canons 33 and 34, now embodied in Model Rule 5.4], which prohibited lawyers from sharing an ownership interest with nonlawyers in any business venture that involves the practice of law. In fact, the prohibition on fee-splitting coincides with the rise of the large law firms. To take advantage of the myriad of economic opportunities that accompanied the end of World War II, the great financial and industrial enterprises of the day needed to tap into the legal expertise of the relatively small number of law firms with sophisticated experience with large corporate clients.

To be in The Am Law 100 today, someone at your firm needed to be at the right place with the right skills a long time ago. Among the firms in The Am Law 100, the average name partner was born in 1895 and died in 1964. The “young firm” exceptions—Wachtell, Lipton, Rosen & Katz; Skadden, Arps, Slate, Meagher & Flom; Boies, Schiller & Flexner; and Quinn Emanuel Urquhart & Sullivan—all had something in common with mainstream capitalism: a bold, distinctive strategy that was highly valued by clients. But alas, even without such a strategy, there was still plenty of work to ensure that the old order still prospered.

Today, however, the ecosystem is dramatically different. Over the last several years, large law firms have grown beyond the available food supply of high-end corporate legal work. At the same time, many new entrants, particularly in the law and technology space, are making a profit providing services that some might call a commodity but others know as the bread-and-butter operational legal work that supports a sizable portion of the traditional large law firm. In the 2012 ALM–LexisNexis survey, 91 percent of managing partners acknowledged that their firm had “unprofitable partners,” and 70 percent of managing partners reported that such partners were at risk of deequitization or removal. We suspect these statistics have less to do with lazy partners than the fact that established methods of hunting and gathering are working less well for the tribe as a whole.

Law firms love to grow. For most partners, it is a familiar and cherished state of affairs. But to grow revenues through a lateral acquisition strategy that dilutes rather than grows the profit pool is to mate on the basis of the peacock’s large, colorful tail.

If a law firm wants to increase its odds of surviving well past the current mating season, it needs a strategy that fits the new corporate law ecosystem—one that is focused more on meeting client needs and institutionalizing those relationships rather than increasing partner profits in the current fiscal year. Having a realistic, focused firm strategy provides an objective basis for screening candidates that do or don’t help the cause. More importantly, having such a strategy is probably the most effective way to attract lateral candidates who fit your organization, as opposed to the larger proportion of the candidate pool that is looking to maximize the size and duration of their guaranteed contracts or, alternatively, escape the axe at their current firm.

That said, we have little doubt that many law firms will figure out a successful way to adapt. This species is not prone to rapid, abrupt decisionmaking. But over the long haul, it tends to make good decisions.

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