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# When Key Partners Defect

According to some recent news three leading international law firms have been left wondering whether they are the subject of an elaborate April Fool's prank, after seeing a raft of senior London partners all walk out on April 1. My good friend (and former AmLaw 100 executive committee member) who shared with us his views on the Howrey fiasco a few weeks back (see Post #530 – March 16, 2011) today graciously shared his analysis for how to interpret these kind of sudden partner defections…

One of the tell tale signs of instability / pressure in a large US law firm is movement of key players around the end of the first calendar quarter - in the international offices!

Why and how does this work?

**• Most of the international office operations are subsidized by the domestic US base.**

While there are exceptions, this is usually the case. To have a proper platform the US firm has to get outstanding talent, and the only way to do that has been to pay a "premium" to buy that talent in the local market. With a very few and unique exceptions, once you tally up the net benefits associated with the work, and the "take" for the expatriate and domestic team in that office overseas, it is usually a money loser to the overall firm.

**• International operations typically increase the per capita overhead of the firm.**

There are significant costs added to the overhead for accounting and tax preparation, compliance with local laws on the treatment of employees, and almost no economies of scale. In addition, the fixed costs for many items (such as rent of office, housing, food and fuel, and taxes) are higher (London, Hong Kong, Tokyo, Paris), and in many markets one has to pay extra in the nature of housing allowances and other "expat packages" to get their associates and partners to travel abroad and stay for a few years. Many US attorneys are reluctant to go overseas for fear and concern (rightly felt) that it can often lead to their losing touch and the strength of their home contacts, ultimately costing them power and compensation when they return. If things do work out for them, in the nature of developing good business and contacts, they can make very good money, but at the cost usually of having to stay overseas for the duration. Those that tend to stay are often married to a local person or had a life long interest, desire or preference to move away and stay away. They don't necessarily fit will with the US culture of a law firm to begin with, and certainly don't after they have been out for awhile. They do present an attractive talent for other firms moving into those foreign markets, and thus with all these and other dynamics, they can be quite mobile.

**• The foreign talent is able to compete against the US platform when previously it was difficult.**

In some markets (such as China) the ability has evolved for the local talent that you develop to jump ship with clients and offer them comparable services at deeply reduced prices. (for years there was a two tier compensation arrangement established by the colonial firms out of the UK, where local Chinese lawyers received far less money for work, but there was nothing they could really do about it. If they left the firm, the client base was mostly UK and international firms with inbound work . . . so there was no way that they could take the business with them. However, in the last 20 years that has been changing and the power dynamic is now reversed in many regards. Once the local lawyers learn how to handle the domestic and outbound business, they take it away if they can, and they do. But the local regulations about hiring and firing local lawyers and staff that the foreign firms must abide by are very stringent and make it exceedingly difficult for them to lay off people if work slows. So there is a lot of subsidy of that variable cost, one's most expensive component, if work does not come in the door as planned. This feeds the frenzy to buy talent with books of business to keep those people busy, and further distorts the market dynamics).

**• Relatively few partners in the home base benefit from the platform overseas.**

Let's face it, how many members in the US offices actually get a nickel of business from having an office in London or Tokyo? But they all tithe to the increased overhead that makes it possible for partners in London to make fat seven figure incomes and big expense/business development allowances. It would not be unusual for a firm with a small number of offices in elite markets like London, Tokyo, etc. to have a per partner burden of $25k to $75k just for the privilege of having that city on the letterhead. Now, if you are a $2million a year partner that may not bother you. But you can bet a latte at your favorite coffee shop that for a $750k a year partner that a 10 percent per annum "tax" on this type of adventure can grate . . . and after two or three years of significantly reduced income and other pressures that the thought of, "why don't we just dump that mess we got ourselves into over in Brussels" comes up as a proffered solution / criticism.

**• The domestic pressure in the US leads to departures or poor additions, or both.**

The subsidized compensation and benefits and low returns to the US can create serious issues. Powerful US partners who do not like the situation can press for performance adjustments abroad . . . and that results in the foreign partners just jumping to another ship where they can continue to get paid the "goodies". Or the firm can hold firm in defending their decision to "go big in London" (they will never admit to making a mistake in opening or expanding a foreign office), but now is held hostage to a powerful US partner(s) who insists that he/she/they be comparably paid because their performance is so much higher and yet they are making less than those underperforming clods in various overseas offices. This compensation increase has to come from somewhere, and that will be the squeeze on the "middle class" of partners in the US. This can be handled easily by a closed compensation system and nondisclosure . . . for a few years. But then the reality comes eventually that you just are making $50k, $75k, $100k less than your peers in a firm across the street. It can be even worse in firms under severe stress, where a disparity between two equal performing partners can be $25k to $75k for essentially equal performance, the difference being that a particular practice group of office is given preference due to stronger power partners there . . . or a "nice guy/gal" team player getting less because they are taken advantage of. And it definitely happens that way as the firm is squeezed ever more by these dynamics.

SO, the place to do your digging, when you see the departures of big names overseas, is twofold.

**1) Where is the foreign partner going.** If the foreign partner returns to a big name *domestic* firm (say a US firm is left behind for a prestige UK firm) then that is a very high lateral admission hurdle to clear (if it is a London firm) and the talent is probably the 'real deal', not somebody being pushed out for non-performance. This will definitely hurt the operation of the firm they left in the foreign city by removing substantial gross revenues, and add to pressures on the US firm with a dramatically reduced RPL, and higher per capita overhead allocations. If the foreign partner moves to another *US* firm, then there is probably a lesser talent involved, but still a premium paid for it by the new firm.

The typical situation of an addition of these types of players is a big hoopla over all the benefits and returns in the "investment" that will follow in the next couple of years, to justify the premium paid. But it rarely if ever is realized. Only the headhunters benefit from this churn.

**2) What is happening with lateral departures domestically in the US.** The second and most important spot to look is in the US and whether the firm is experiencing some serious "leakage" in the "middle class" . . . the partners who have to be squeezed to pay for all of this and who receive the smallest benefit. They have the chance to take their book of business to a platform without the high costs and get a pay raise for what they are doing already. This is what caused some serious difficulty to Graham & James and to Coudert Brothers, two of the most venerable names in US law firm history with the longest established international platforms. Those firms had partners who made good, but not great money. The partners were very much tied together with a strong culture of international work, loved what they did, and accepted less money for some trade-offs in other respects. But then there were some "pulses" that brought very much higher income. The post 1986 explosion of international work, and inbound US work, with the Uruguay GATT accords (the "General Agreement on Tariffs and Trade"). This attracted new partners who were not surprisingly willing to look at them because of the money level they were enjoying, and not who otherwise were particularly attracted. They had books of business and wanted to make money more than many other competing priorities. When times returned to more "normal" levels of income, they were very agitative and disruptive. While the long term partners were not necessarily unwilling to just settle back to prior levels of operational returns, the newcomers wanted each record year to set the "bottom" of future expectations of financial returns.

Then came some outbound work in the aftermath of the S&L failures and the real estate collapse in the US (and some foreign countries like Japan) where those who had hedge fund traders followed them into international markets for vulture buying. (Paul Hastings, Skadden, Morrison & Forester all benefited from this in Tokyo......whereas Coudert and GJ did not have those client sources domestically in the US and could not follow them back to foreign shores. The indigenous local firms who had the connections to domestic industry and finance were the ones who got the inbound work to foreign nations.) But the economic cycle reverse in 2001 took down GJ, and later in the decade Coudert. Both died when the structure of the firm simply could no longer support the partners that did their core business that delivered the real profits. That core involved work inbound to the US, which shrank significantly when the foreign country based businesses had to pull back on their capital flows to the US, and middle market business and litigation. And the dynamic in both instances was the attrition from the middle class. That is happening again in this cycle of course.

Look at it simply. Lamborghini is a name synonymous with style and performance in an incredibly performing gran tourismo automobile. But it makes no money. It was the passion of an industrial magnate who made his fortune making ........farm equipment, and in particular tractors. The company restructured shortly after its greatest triumphs in design and market acclaim, was bought by several companies in rapid succession, then went to Chrysler, then to Tommy Suharto of Indonesia, then to Volkswagen. It still doesn't make any money. But Volkswagen subsidizes it for a variety of reasons. As long as they maintain their belief that it gives them some benefits and can afford to underwrite it......it will be accepted.

In a law firm, the same thing is at work, but the decision over whether it makes sense to maintain the subsidy is ultimately with each individual shareholder, and their departure in numbers can have the prospect of destroying the company, even though each of them is a small piece of the operation. Nobody will ever say that the international adventure is what destroyed the firm. The leadership surely will never say that. And the departing partners just want to keep their heads down, get their capital out, and go on with life as undamaged as they possibly can. But follow the money trail. Who is receiving benefit from the adventure, and who is paying for the adventure. When the delta gets too big . . . folks jump ship. The occasional foreign lateral hire / departure mistake is unavoidable. But if there is a domestic corollary in mid level departures . . . watch out!