Industry Trends

Free Agency: The Pathway to Great Lateral Talent

Are you competing effectively for talent in the "player draft?"

By Allan D. Koltin

Q: What are the current trends and opportunities when it comes to recruiting and hiring in lateral talent?

A: Since the demise of Arthur Andersen in 2002, more lateral talent has moved from the Big 4 to local, regional, and middle-market national firms than in the three prior decades combined. The apparent trend was a realization by high-performing partners, principals, and senior managers at the Big 4 that they could make the same kind of money (and in some cases, more) at local, regional, and middle-market national firms. The surprising trend, however, has been how the highest performing firms have been getting more strategic and doing a better job of identifying strategic needs and opportunities in their firms and then making the necessary financial investment to go into the market and fill those gaps.

Q: What is the biggest challenge or obstacle when bringing over lateral talent?

A: It typically revolves around the lateral partner's book of business and/or client relationships that the departing lateral worked on. Whether we call it the chicken or the egg or the cart before the horse, clearly when firms hire partners with books of business, these types of transactions are much more complex than when a partner is simply leaving Firm X and joining Firm Y (without any clients following). In essence, you have to begin by creating a decision tree that looks something like the following:

1. What will the compensation program be for the lateral partner, assuming he or she brings over a majority of his or her book of business? Obviously, we also need to know what the non-solicitation provisions look like as they relate to the relationship with the firm the partner is departing from.
2. What will the compensation program look like if no clients are following, but there is a high likelihood that clients will ultimately follow over some period of time (and, hence, not be subject to the non-solicitation provisions)?
3. What type of compensation program will we have, assuming a lateral partner comes over but none of the clients will follow? Here, we need to find a way to bridge the "market value gap" in compensation, and the acquiring firm has to assess what type of financial investment it will make in the lateral partner while he or she rebuilds his or her book of business.

Q: You and your firm have represented numerous lateral candidates, as well as firms on both sides of this equation. Can you break down what's at stake for all three groups (*i.e.,* departed firm, acquiring firm, and lateral partner)?

A: In terms of the departed firm, it typically needs to "hold court" and enforce the non-solicitation provisions of the departing partner's agreement. It typically calls for the departing partners to pay 1.5 to 2 times the revenue base that they are taking with them. Having said this, often there is a negotiation (this is where we try to mediate!) as it relates to the dollar amount and payment terms. The departed firm has an obligation to enforce the terms of the agreement, yet in the same breath it has to exercise “practical reality.” If the payment terms are too onerous, the lateral partner may simply leave and clients could go elsewhere, which is always a risk. That being said, it is important in this type of discussion not to draw hard lines in the sand, but rather to look at making a deal that all three parties (*i.e.,* departed firm, acquiring firm, and lateral partner) can live with.

In terms of the acquiring firm, it will typically bring the lateral partner in as an income partner (no capital or equity exchanged) and will set performance goals for six months, one year, two years, and potentially as far out as three years. It is critical that the acquiring firm, along with the lateral partner, put together a three-year budget that takes into account expected revenues and expenses along the way. Clearly, a big issue for the acquiring firm to deal with is who will be “writing the check” to the departed firm. Will these clients, in fact, be purchased by the lateral partner or will they, in essence, be purchased by the acquiring firm?

The third part of the answer deals with the lateral partner. Clearly, the lateral partner is the most at risk and needs assurance from the acquiring firm that he or she will definitely have a job offer whether the partner comes with or without clients. This is always a tricky item and often it is a good idea to pro forma two to three different scenarios so that both the acquiring firm and the lateral partner are in alignment from an expectation standpoint regarding what compensation will look like.

Q: How do you quantify or get your arms around how much new business lateral recruits or partners may bring with them?

A: I often ask the lateral partner to put together an A, B, C List as follows:

- *A List.* These clients are loyal to you first and the departed firm second, with a high likelihood they will come over with you.
- *B List.* These clients like both you and the departed firm and probably use the firm for multiple services. They may, in fact, have multiple service providers on the account. Clearly, these will be more difficult clients to move, but that’s not to say they won’t move.
- *C List.* Even though you work on these clients and have good relationships with them, the probability of them leaving is relatively low for now. That being said, it would not be unlikely that the clients might be able to join you once the non-solicitation period is up.

However, there are agreements out there that put restrictions on departing partners well beyond two years (some as many as five years) as it relates to the solicitation of clients and some also have geographical restraints as to where departing partners can and can’t practice.

Q: Is there a typical negotiating posture that the departed or acquiring firm will have in dealing with these issues?

A: Great question! The first question I ask laterals when they are looking to relocate is who the departed and acquiring firms are that we'll be dealing with. While you might think that all firms approach this issue in the same way, there are some noticeable differences in the negotiating styles and vantage points with which these discussions are handled. Some firms have said to me that they don't want to keep partners at their firm against their will and if, in fact, they want to leave, would rather they be up front about it. All they ask is that they be fair in terms of paying for the assets they are taking with them. Other firms are much less liberal in their approach and will take a much harder stance. While the hardline stance may appear to be the way to go, I'm not sure that some of those firms would answer the question the same way after they have spent hundreds of thousands of dollars in legal fees litigating and trying to enforce their partnership agreement. I've had firms say to me, "If I could do it all over again, it would have been wiser to settle out of court," and I've also had firms say to me, "We'll go to the mat each time someone wants to leave and not pay for the clients they take with them."

Q: Are there certain dates or times of the year when it is more advantageous to bring a lateral into the firm?

A: In fact, there are, and they typically revolve around the service line or industry line that the lateral hire represents. It is important that we know what is typically the "selling season" because that is when most new business comes in and new engagement letters are entered into. Conversely, there are certain times of the year when prospects are less willing to move or even entertain changing CPA firms.

Q: I assume partners will often want to bring other partners or associates with them when they leave. What advice have you given to both groups?

A: When I review partnership agreements, I am always amazed when firms don't put certain restrictions in their agreements to make leaving the firm that much more difficult. I believe it's fair to have a provision that says partners of the same firm can't leave together and start a new firm for some period of time. I also believe it should be made expensive for partners to leave a firm and take staff with them. Believe it or not, I still see agreements where there is no penalty for staff leaving or, at most, the penalty is 35 percent of the departing staff person's compensation. (I guess it's 35 percent because typically that is what a search firm would charge to find a replacement candidate.). I believe the figure should be closer to one times compensation for a departing staff person as a financial penalty should they leave with a departing partner because the replacement costs are well above one third of a lost staff person.

Q: Is it a good idea for the acquiring firm and/or the lateral partner to have a defined honeymoon period or breakup clause, similar to that which we sometimes see in a merger?

A: Similar to the advice I give in the merger arena, I would say that I'm not a big fan of honeymoon clauses or breakup provisions. I find all too often these become self-fulfilling prophesies. Could you image if in the "real world" every marriage that took place in the United States came with a honeymoon or breakup clause? My guess is that the divorce rate would jump from 50 percent to 75 percent within a year. Safe to say, in all new relationships the first year will have the highest degree of difficulty and I think both sides should enter into the relationship 100 percent committed to making it work and only if it can't work should they then sit down and try to negotiate something that is fair and equitable.

Q: What are the main areas that acquiring firms are looking for in lateral partners today?

A: The following is a brief list of qualities that seem to be high on most firms' lists:

- Rainmaking skills;
- Leadership/management abilities;
- Can assume someone else's book of business;
- Can help to leverage another partner's book of business;
- Has a unique or specialty expertise that the firm doesn't have or wants to expand upon;
- Satisfies an age, experience, or diversity gap the firm wants to fill in certain places; and
- Can take partner book and cross-sell other services.

Q: What are some of the trickier issues to consider when lateral partners join the firm?

A: There are a handful of questions to ask, such as the following:

- Do they have the same client service mentality that we do (high leverage vs. hands-on)?
- Is their billing and collection philosophy similar to ours?
- Do they treat staff the same way we do?
- When it comes to partner compensation, are we philosophically aligned?
- Will they be able to adapt to our culture and business philosophy along the way?

In closing, while nothing in business, or life for that matter, is ever 100 percent guaranteed, I do believe those firms that have been investing in lateral talent over the last decade have seen not only a dramatic spike in their growth, but also significant increases in profit per partner.

About the author: Allan D. Koltin, CPA is the CEO of Koltin Consulting Group, based in Chicago, Illinois. Allan specializes in the areas of partner compensation, firm governance, profitability, strategic planning, succession, practice growth, human capital, executive search and mergers and acquisitions. He can be reached at either *akoltin@koltin.com* or 312-805-0307.