fairfax INSIGHTS

Merger Discussions: A Balancing Act

Managing merger discussions between two law firms can be tricky. Recently we have seen firms struggle with getting the right balance between discussing the business case for merger and delving into some of the deal terms of the combination. The business case – including the benefits to clients and partners of the merger – must be robust and genuine. The business case is the rationale for the combination. But while the best business case can motivate firms to overcome thorny deal issues, it cannot overcome deal breakers. Therefore, genuine deal breakers need to be identified early enough in the discussions so that the two firms aren't investing valuable time in discussions that won't result in a combination.

Firms who kick off with and focus on the deal terms risk losing the focus on the bigger picture. They are likely to lose enthusiasm when faced with challenging issues because the negotiations end up being the focus without the context of the benefits that the combination can deliver. And without an articulated business case, skeptical partners are more likely to find fault in a potential combination.

By contrast, firms who focus myopically on the business case often involve many of the firm's lawyers, and invest very significant amounts of time. This investment is critical of course, but needs to be sequenced appropriately. Getting broad partner engagement too early has some risks. Some partners may not be fully on board with a transaction and look for other options. And as the number of people involved increases, the likelihood of the discussions becoming public increases. While the latter may be manageable, the former can leave the firm in a weaker position should the discussions not go forward.

Getting the balance right is critical. In our experience there are several steps that can help the discussions move along, keeping the development of the business case and deal terms in step with each other.

Know Thyself

Before embarking on merger discussions it is important to look introspectively and think about what is important to the firm and the partners in the context of a merger. While it is easy to say that the firm would be flexible for the right deal, the reality is that this is not always the case. Partners, who ultimately hold the power to vote a merger up or down, often do have strongly held views about structural aspects of the firm that are important to them. Spending time up front identifying potential deal breakers and determining which are seen to be non-negotiable helps raise these issues early and before extended discussions with another firm occur.

While of course conflicts, profitability differences, and cultural differences are all more obvious potential deal breakers, there are often other issues that are more firm specific. One that can raise strong opinion is that of governance and decision-making. Some firms, and indeed some firm leaders, feel strongly about holding key leadership roles, while others do not. Sometimes these leadership positions are seen as a signal to the partners that the combination is a merger rather than an acquisition.

Another deal breaker is the existence of a significant unfunded partner retirement plan. Emotions run surprisingly high around unfunded retirement plans. Firms who don't have them can view them as a tax on partnership profits, or that they are paying for benefits that they will never receive. Firms who do have them may feel they have paid into the plan for years, and aren't willing to give up their benefits. Long frozen plans are easier to manage than currently active or recently frozen plans where not only the obligations will be higher but there will be seen to be two classes of partners.

The key is to identify the issues that your partners care about before discussions start, and not six months into the discussions.

Follow a Plan

Merger discussions can sometimes meander along from meeting to meeting without a clear direction or plan. While plans don't need to be rigid, it is helpful for the leadership of the two firms to have a conversation about the pace and focus of discussions. The plan should map out the dual tracks for exploring the business case and discussing key potential deal terms. There should be key milestones at which each firm steps back to make a go/no-go decision. Each firm needs to give some thought to how and when to broaden the group involved in the discussions and what information they need about both the business case and the possible deal structure in order to take the step of broadening the group.

Structure the Deal Discussions

Deal discussions can also meander if not appropriately structured and led. We find that an early discussion around each key structural issue is an important step. The two firms don't need to reach a resolution on each issue at this stage but they do need to feel comfortable that a viable resolution *can* be reached. It is important that the key deal breakers that each firm has identified (as described earlier) are discussed at this point. Once the firms have had the high level discussions they can map out a plan for working through both the thorny and the more routine deal issues.

It is also critical to get the right people involved in the deal discussions. Occasionally firm leaders will delegate these discussions to a 'deal team', who may not have the same vision for the combination as the leaders. They are more likely to be representing their 'client' (the firm), and focus on 'winning' the negotiations, rather than maximizing the competitiveness of the combined firm.

Structure the Business Case Discussions

Firms are very good at talking about their own firm, practice strengths and clients. But the business case is ultimately about how the two firms/practices will be more competitive together and the conversation and analysis must address how the combined firm will be more competitive in the market and can better service existing clients and/or win new clients and work that neither firm could attract independently.

Two firms which are able to achieve or solidify a market leading position in a particular area of practice have a strong case for merger. Or which are able to combine complementary practices with compatible client bases and a high likelihood of being able to cross-service. Or which share key clients or have compatible industry strengths that create a market leading position. The business case must address not only the current position of the combined firm, but the position they seek to reach in the rapidly evolving market. For a merger to drive real long term value, the business case must reflect a strategy defining how the firm will outcompete the market, both in the near and longer term. Having a framework for the overall business case can help structure the discussions and the thinking of the two firms so that the business case can be effectively articulated to the partners, and ultimately to clients and the market.

It is particularly important once practice groups start meeting independently to ensure that they come out of their meetings with a strong sense of the business case and not just a catalogue of each firm's practice. A structured agenda and a clear framework for the output can help guide the practice groups.

Many merger discussions do not result in a combination of two firms, often for the right reasons. The key is to make sure that you structure the discussions appropriately and get key issues on the table early so that you don't invest scarce time and resources in a deal that isn't going to happen. Getting the balance right can make the difference.

London

Principal: Giles Rubens
giles.rubens@fairfaxassociates.com
44 (0)20 3633 3943

Washington

Principal: Lisa Smith
lisa.smith@fairfaxassociates.com
202.365.4180

California

Principal: Kristin Stark
kristin.stark@fairfaxassociates.com
415.215.9294