fairfax
INSIGHTS

When is the Right Time to Merge?

In recent years, we have worked on a number of law firm mergers where one of the firms was in a significantly weakened position relative to its past. More often than not, these mergers fail to move forward because there is too much uncertainty about the stability of the firm, the deterioration of its financial condition, and the questionable commitment of key partners to remain with the combined firm. The potential merger partner is unwilling or unable to take on the risk associated with a merger which may have strategic value but brings institutional risk.

While these firms are often small and midsize firms, including founder firms, we have seen larger firms in this weakened position as well. These include firms that have talented, high performing lawyers and had, at least at one point in their history, a distinct and competitive market position. The current pandemic is exacerbating these challenges as reduced demand has hit some firms hard, even while others have maintained demand or even thrived.

We have identified four issues common to these firms. Learning from their experiences can help firms recognize the challenges and either seek merger before it is too late or look for solutions to steady the firm.

Concentration of Client Relationships. While concentration of the control of client relationships is often the case in founder firms, it can also exist in second generation firms where a small number of partners hold key client relationships. While this model may work for a period of time, client relationship concentration, as well as client dependency, often create challenges in the long term. When senior partners maintain tight control over client relationships, succession planning can become difficult, if not impossible. Other lawyers may work on matters for the client, but none are given the opportunity to develop a strong relationship with the client. This dynamic can lead to a 'hollow middle', as young partners who had the capability to take over client relationships recognize the lack of opportunity and depart the firm, and those remaining operate as service partners. Or in some cases, if young partners are successful in developing their own business, they are often undervalued and undercompensated relative to the market and find better opportunities to advance their careers elsewhere. Further, the firm is often overly dependent on just a few clients or partners, and the loss of either one can have an outsized impact on the firm.

Concentration of Decision Making. The same dynamic happens around firm management. The partner or partners controlling the firm can be reluctant to transition leadership and management responsibilities, or if they transition on paper, they maintain a heavy hand in decision making behind the scenes. As the generations transition, it can leave the firm with weak leaders who are not well positioned to make difficult decisions.

A further risk of concentrated power in a few senior lawyers is that they are more likely to see trends through the lens of history as opposed to the current or future position of the firm, and therefore fail to recognize the impact of market changes on the firm. There is often unwarranted optimism that market changes are short term and that the firm will return to its former glory soon. This results in friction within the partnership and the departure of promising younger partners.

Compensation Issues. For lack of a more elegant term, greed can also be an issue that weakens firms. Some partners will focus on maximizing their current income rather than thinking about the long-term stability of the firm. While it is natural to want to be paid fairly for contributions to the firm, partners will hoard relationships and origination credit in order to maximize income, which then contributes to the challenges discussed above. These partners may also control the compensation decision making process to ensure self-serving outcomes.

In founder firms, there can also be an expectation that the founding partners will continue to be paid at a high level while working less, or that they will receive a significant buyout for their role in building the firm. The hard truth is that a material or prolonged premium for founders is rarely available in law firms, and in small and midsize firms, this approach is likely to result

© Fairfax Associates

in inadequate income to pay the remaining partners fairly. Further, if client relationships are eroding due to succession issues, the prospect of reasonable future income for the next generation of partners will be low relative to the premium they are being asked to pay the founders. As a result, these partners are more likely to seek opportunities elsewhere.

Protecting Culture. While firm culture is indeed important, too many firms use culture as an excuse for avoiding tough decisions or necessary action. In some of these firms, culture becomes a synonym for autonomy for senior partners or rainmakers who want to run their practices independently and without firm constraints, even if it runs counter to firm success and survival. In other firms, there can be a complacency that results from relying on a handful of rainmakers to drive business for the firm.

Culture is often the primary reason small and midsize firms are reluctant to consider merger opportunities – there is concern about letting go of decision-making, being part of a “large bureaucracy”, meeting elevated expectations for partners, or not being the biggest fish in the pond – even when a combination with another firm could benefit both the firm’s partners and its clients.

Considering Merger

High quality small and midsize firms in key markets are regularly approached regarding combinations with other firms – both larger and similarly-sized firms. When times are good, these firms are generally not interested in pursuing a discussion. When times get tough, they are more receptive to merger as a solution, but find that either potential partners are no longer interested or their negotiating position is substantially weakened. In some cases, these firms end up dissolving.

The key to avoiding this worst-case outcome is to be realistic about the firm, the market, and the options. Ask some of the following questions:

- Are our clients looking for more from us – more depth or breadth of practice or geography?
- Are we seeing increased competition in our practice or market?
- Are we seeing our share of wallet with clients shrinking?
- Is there more value in keeping the firm together than breaking it up? (For collections of solo practices, the answer may be no.)
- Do we want a stable entity for our lawyers and staff?
- Are we able to attract and retain our best talent?
- Is maintaining our culture in the short-term worth losing the firm in the long term? (This is not a rhetorical question - for some founding partners the answer may actually be yes.)
- Given the changes in the market and within the firm’s talent base, can the firm realistically maintain its competitiveness and vibrancy over the next 3 years? 5 years?

The sooner the firm recognizes potential changes taking place in the market and within the firm, and the implications of these changes, the more options the firm will have to address them. If merger is one of the options under consideration, the firm may need to explore merger earlier than expected in order to find the best fit and most attractive terms.

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

© Fairfax Associates