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Positioning for Merger

We have seen an uptick in law firm merger activity and interest in recent months, as firms look to build competitive position, add practice depth and breadth, and retain key lawyers. Based on our work with firms considering merger or engaging in merger discussions, the time is right to revisit one of our past Insights on determining the right time to merge and, once a firm has determined that a merger is the right path, preparing the firm to be well-positioned for merger.

High quality small and midsize firms in key markets are regularly approached regarding combinations with other firms – by 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 can find that either potential partners are no longer interested, or their negotiating position is substantially weakened.

When a firm is in a weakened position relative to its past, there is often uncertainty about the stability of the firm, the deterioration of its financial condition, and the commitment of key partners to remain with the combined firm. A potential merger partner may be unwilling to take on the risk associated with a merger which may have strategic value but brings institutional risk.

While these 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 have had, at least at one point in their history, a distinct and competitive market position.

We have identified five issues common among 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.

Loss of Partners. Partners with business are far more mobile than in the past, and lateral partner hiring has increased significantly in recent years, including more group moves. The loss of a few important partners or a key practice can destabilize a firm quickly. This issue is exacerbated when the control of client relationships is highly concentrated. When 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.

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. A risk of concentrated power in a few senior lawyers is that senior leaders are more likely to see trends through the lens of history as opposed to the current or future position of the firm, and therefore they often 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 to maximize income, which then contributes to the challenges discussed above. These partners may also control the compensation decision-making process to ensure control over 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 in inadequate income to pay the remaining partners fairly. Further, if client relationships are eroding due to succession issues,

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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 complacency and a greater tolerance for underperforming partners that results from relying on a handful of rainmakers to drive business for the firm.

Culture is often the stated 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.

Excess Infrastructure. Finally, firms who have stagnated or shrunk can find themselves with excess space, an operating structure that is geared to a larger firm, and the resulting high operating expenses per lawyer. While firms can manage some aspects of the expense structure, the fixed costs typically have limited flexibility in the short term.

Is it Time to Consider Merger

The key to avoiding a 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 our share of wallet with clients shrinking?
- Are we able to attract and retain our best talent?
- 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, it is important to take a critical look at the firm from the perspective of potential merger partners. This starts with the strengths the firm brings to the table but must also include the challenges. The strengths can include the client relationships and opportunities to build on those relationships in a broader platform, firm and/or practice reputation, industry depth, practice expertise and depth, profitability of the firm, quality of work, and the culture, among others. The challenges are sometimes harder to pin down but include factors such as losses of partners or clients, declining revenue and profitability, fixed expenses (e.g., occupancy costs) that exceed norms, high debt, unfunded obligations such as partner retirement plans or buyouts, financial practices such as deferral of expenses or bonuses that will create financial pressure on a combined firm, and the like.

Once the challenges are clear the firm needs a plan to address them in the context of a merger. A firm can't assume that another firm will happily take on all the challenges. What steps can the firm take to reduce the impact of challenges and what are partners willing to give up to complete a merger? As important, are there any non-negotiables from the firm and partner perspective, and are these non-negotiables going to present barriers to certain mergers?

Being clear eyed about the firm's competitive position, strengths, and challenges can help the firm look for solutions, including merger, before the problems start to stack up, and the options become more limited.

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