Law Firm Mergers: What's the End Game?

Ward Bower

By Ward Bower

There have been more than 170 law firm mergers in the US in the last three years. Although the pace has slowed since a peak of 82 in 2002, there is no end in sight.

What's Driving This Merger Activity?

There are a number of drivers of this unprecedented level of law firm merger activity. They include the following:

Consolidation — Maturation of the legal services market is following the same pattern as other professions and service industries, such as accounting, investment banking, consulting and financial services. One aspect of marketplace maturation is consolidation – rapid growth in the size of service providers, much of that growth driven by merger. That is how the Big Eight became the Big Six, then Five, now Four. The pace of consolidation in the legal market has been a bit slower due to regulatory constraints that do not affect these other professions and service industries, most notably provisions regarding conflicts of interest. However, that has not precluded mergers on the scale of, for example, DLA/Piper Rudnick Gray Cary (2,700 lawyers), Jones Day/Gouldens (2,000+ lawyers), Kirkpatrick & Lockhart/Nicholson Graham & Jones (almost 1,000 lawyers), and others of comparable scale now under negotiation.

Hand in hand with consolidation by merger goes the "shakeout" or business failure of firms unable to compete. Notable recent examples include significant firms like Brobeck Phleger & Harrison, Testa, Hurwitz & Thibeault, Altheimer & Gray, and Arter & Hadden. Dissolution of large firms frequently fuels consolidation as large groups of lawyers from those firms join other firms, accelerating their growth. Sometimes firms experiencing economic difficulties on partner defections will seek a "white knight" for a defensive merger, putting themselves up for acquisition by a stronger firm.

Client Mergers — Mergers in business and industry create larger clients with greater, more sophisticated legal requirements, and they frequently seek representation by larger law firms that presumably have greater breadth and depth in their specialty areas. Some law firm mergers are driven by a desire to represent these larger clients.

Market Share Strategies — Some mergers are driven by law firm strategies to capture market share and achieve dominance in a market segment. If a supplier can dominate or even just survive in an oligopoly, it can influence pricing and arguably convert the current buyers' market (where clients dictate price, staffing and strategy) back to the sellers' marketplace of 20 years ago (where suppliers dictate price, staffing and strategy). Achievement of this type of dominance is possible on a geographic, practice area or market segment basis, but is difficult to sustain. New competitors will target such markets and compete on the basis of price, thus restoring competition.

Law Firm Growth Strategies — The growth imperative in professional services is driven by a need to provide opportunity for professional development, advancement to partnership, and access to bigger and better clients and more sophisticated work. Organic growth by addition of new associates is often supplemented by lateral growth or growth by merger. Growth by merger can be driven by scope (increasing

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practice areas or geographic reach), or by scale (increasing depth in existing areas of practice and in existing offices to appeal to bigger clients and clients with more sophisticated needs). An objective of growth by either a scope or scale merger is not only to attract bigger and better clients, but to improve a firm's ability to recruit at both the associate and lateral partner levels. This is especially true for mid-sized firms seeking to achieve status as leaders in their marketplaces, thereby improving their competitive positions in the marketplace for legal talent.

"One-Off" Merger Strategies — There are also merger strategies that address specific needs, such as filling age or experience gaps, providing an exit strategy for aging owners, or "trading up" by first increasing specific capabilities then culling the weaker components of practice areas or offices.

There are some rationales for merger that are essentially flawed. For example, the myth of economy of scale, in the sense that there is none in law practice. Surveys consistently show that larger firms spend more on overhead, on a per lawyer basis, than smaller firms. This is counter-intuitive, but nonetheless consistently true over the last three decades, as demonstrated in the annual Altman Weil *Survey of Law Firm Economics.* Mergers driven by ego (generally first-generation firms), or "follow the leader" strategies (everyone else is doing it), also are likely to fail.

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How Successful Have Law Firm Mergers Been?

Data enabling evaluation of merger success are available only in situations where larger firms are involved. Anecdotal evidence suggests that merger of larger firms generally have been successful as measured by pre- and post-merger evaluation of profitability (See, "Are Large Law Firm Mergers Successful?" by Ward Bower, Altman Weil *Report to Legal Management*, September 2003). That anecdotal study also suggests that scope mergers provide greater and more immediate improvement in profitability than scale mergers, and that either geographic scope or practice area scope mergers provide a greater improvement in profitability post-merger than scope mergers based on a combination of geography and practice area.

What Is the End Game?

Are we likely to see one giant global law firm? Or two, in order to avoid conflicts of interest? A "Big Four" of law firms, as in the accounting profession? These scenarios are highly unlikely, at least in the foreseeable future.

What we do see are emerging tiers of large law firms defined by geographic markets and capabilities in areas where talent in the form of credible, experienced practitioners is limited or where client needs are specific and defined. Many mergers will be driven by desires to compete on a global, international, national or regional scale, seeking to achieve a position in one of the following tiers:

Global Capital Markets — These will be large firms with significant, credible on-the-ground capabilities in both New York and London in the areas of project finance/infrastructure and corporate finance. Large capital markets projects around the world are typically drafted and interpreted, and disputes resolved, under either the law of England or of New York State. Capability to handle a project under the law of either jurisdiction is a significant competitive advantage. Both the supply of talent and the demand of clients, however, are such that it is likely that only a half dozen to a dozen firms will achieve this status. Aside from the critical mass of capital markets practitioners necessary in both New York and London, size will be less important to these firms than in other categories. As Asian economies develop, it is likely that a third capital markets capability will be necessary to achieve global capital market status, probably in China.

Global Corporate and Commercial — These firms will have offices in dozens of corporate, commercial and banking centers worldwide. They may achieve a size of 5,000 to 10,000 lawyers; some may be capital markets players, as well. Clear examples have already emerged – Baker & McKenzie, Clifford Chance, DLA/Piper Rudnick Gray Cary, Jones Day, etc.

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National/International Firms — Smaller than global corporate and commercial firms, these firms are likely to be national in scope in their country of origin with international offices, but less than global. Examples would include New York or national firms in the US with one or two European offices. Firms originating in continental European countries, Australia and Canada have also achieved this status. More will seek and achieve it in the future.

Domestic Importers — Thousands of local, regional and national firms without foreign offices will compete in the international marketplace on the basis of their serving as a firm of choice for "one-stop shopping" in various countries and regional jurisdictions. They will actively cultivate foreign clients and referral sources to provide domestic legal work to foreign businesses and investors in their jurisdiction of origin. National firms in the US with this status include Holland & Knight, Baker & Hostetler, and Sonnenschein. Regional domes-

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tic importers would include Nixon Peabody, Frost Brown Todd and Adams and Reese, all of whom have employed merger as a regional growth strategy. Some of these firms will eventually expand internationally to provide on-the-ground foreign services to their domestic clients, rather than referring that work to foreign law firms.

Conclusion

We can expect to see a dynamic, multi-tiered global, national and regional marketplace for legal services with winners, losers, and spin-offs of groups of lawyers not wanting to practice in a larger firm environment. Merger will continue to influence the profession into the future. Some firms will flame out, as in recent dissolutions of large firms not sufficiently competitive in their marketplaces. Failed firms will result in reconsolidation with other large firms, in turn accelerating growth.

Continuing law firm merger activity will present both opportunities and threats in the legal market. Firms will need coherent strategies to succeed in a rapidly changing marketplace. Clients will need constant vigilance to assure themselves that their needs are being met most effectively and efficiently, and they will need to reconsider outside counsel options regularly due to the rapidly changing marketplace. ◆

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