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Merging Law Firms

Ward Bower

By Ward Bower

Editor's Note: This is the first of a two-part article. Part Two will be published in next month's issue of RTLM (March 2008).

Clearly the legal profession is consolidating by merger. Consolidation frequently occurs as industries mature. It has already happened in other professional and service industries such as accounting, consulting, banking and insurance. Consolidation by merger is the primary method by which the Big Four accounting firms emerged, and merger continues in financial services industries, as regulation allows, both intra-industry (e.g., banking) and inter-industry (e.g., insurance and investment brokerage, banking and insurance). Until inhibited by provisions of the Sarbanes Oxley Act, combined accounting/consulting/law firms in the form of MDPs (Multi-Disciplinary Partnerships) had emerged on an international scale, led by major global accountancies.

The pace of consolidation of the legal profession has been slower than in other professional service industries due to a different, more restrictive regulatory environment. Conflict of interest rules for lawyers are a greater impediment to law firm mergers than conflict rules are to mergers of accounting or financial services firms.

Why Do Law Firms Merge?

Many reasons are given for law firm mergers. Some are more persuasive, or more valid, than others.

Merger as a Strategy, Not a Goal

Merger is not a legitimate business goal in and of itself. Rather, it is a strategy to achieve a goal (such as growth) or a tactic employed to achieve a strategy (such as diversification or geographic expansion).

Legitimate Reasons to Merge

Sound mergers of law firms are those intended to add new specialized services needed by a law firm's clients, to add clients needing a law firm's specialized services, to gain access to new and better clients, to extend geographical reach to new markets, to fill age or experience gaps, to achieve critical mass in a consolidating marketplace, or to achieve market dominance or enhanced market position by becoming a "top tier" firm in one's market. "Short lists" of top tier firms generally are considered for engagement by corporations in the absence of an established relationship with firms in the marketplace.

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Defensive Mergers

Mergers can be defensive, intended to avoid disintegration or demise of a firm due to lack of leadership or declining performance. Defensive mergers often do not include all of the components of a weakened or threatened firm. However, mergers of two economically unsuccessful firms almost never succeed. Predictably, such mergers result in a larger, economically distressed firm, in turn vulnerable in the marketplace.

Invalid Merger Rationale

Law firm mergers have been attempted for other reasons that are not generally valid — to fuel egos of founding partners, to remedy poor economics, or because everyone else seems to be doing it. Mergers to achieve economies of scale are suspect, as economies of scale are limited in law practice. Bigger firms on average spend more, not less, on overhead, on a per lawyer basis. Statistical surveys, such as the Altman Weil *Survey of Law Firm Economics*, have demonstrated this for decades.

Bigger Equals Better?

The result of a consolidation is bigger law firms. Bigger is not necessarily better, although statistical surveys consistently show greater profits per partner in larger law firms than smaller ones, driven by higher revenues per lawyer. Bigger is only better if the value proposition presented to clients (breadth or depth of practice, achievement of critical mass needed to handle bigger matters, extended geographic reach, etc.) results in the ability to generate more work and/or work for which clients are willing and able to pay higher rates.

Survey Data — Law Firm Mergers

Recent studies show merger is one of the top business techniques employed by large law firms. A 2005 survey by Altman Weil asked AmLaw 200 firms (the 200 highest grossing law firms in the US) to identify, from a list of 24 management techniques, which they have employed and how successful they have been. Almost two-thirds of responding firms had merged within the preceding two years, and almost 90% of those firms indicated their experience with the merger was either "very successful," or "successful." Figure 1 depicts the complete results with respect to merger as a management technique in larger law firms.

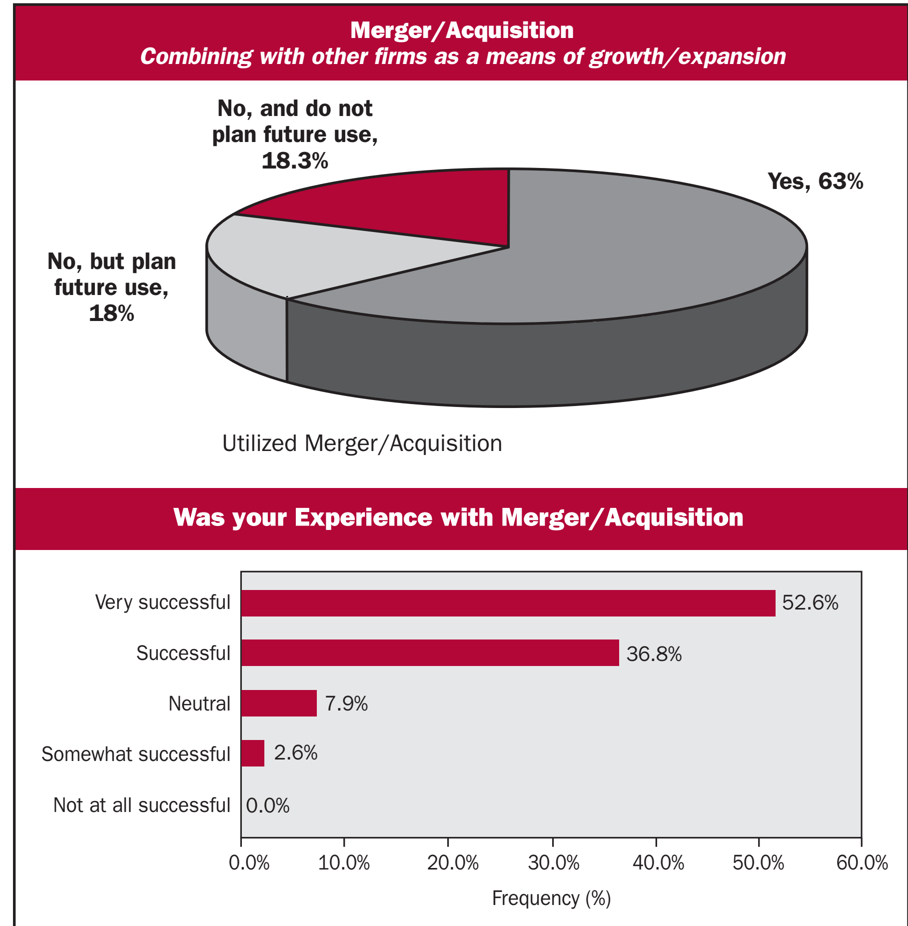
Law Firm Mergers vs. Corporate Mergers

Law firm mergers are different and more difficult than corporate mergers. Corporate mergers generally create more profitable businesses when economies of scale reduce unit costs of production. For example, when banks merge, increased productivity and profitability generally results from reductions in staffing and increased application of information technology.

Since production in law firms is tied directly to professional staffing, opportunities to increase profits through downsizing are limited. Cost reductions through elimination of redundancies in law firm mergers are generally offset by transaction and integration costs, or increased costs inherent in operation of a larger law firm.

Corporate mergers can be accomplished when management of two companies decide to merge and order the integration to occur, or when management of one or both companies persuade shareholders of the company to be acquired to vote for a proposed merger or takeover. Once the merger is announced, management has authority to order the

Figure 1



integration to occur. Some corporate takeovers are "hostile," and occur despite the desire of management or shareholders of one firm to remain independent.

Unlike the hierarchical corporate governance model, law firms are generally flat, horizontal organizations where owners and managers are also producers and much greater buy-in is required to approve and implement successful mergers than is the case in a corporate environment. The Chairman of an AmLaw 100 firm that pulled out of merger talks with an AmLaw 50 firm in early 2007 cited the difficulty in getting large numbers of owner-lawyers to "buy in" to a law firm merger as the major impediment to that proposed deal.

External Drivers of the Consolidation

Law firm consolidation by merger is driven not only by the internal business needs of law firms, but also by events in the larger economy as a whole.

Bigger Clients

One external driver: clients are getting bigger. The most desired clients of most US law firms are corporations, both publicly and privately owned. Since 2000, corporate mergers and acquisitions are occurring at unprecedented rates, increasing dramatically in 2006 and barring unforeseen political, economic, manmade or natural disaster, expected to continue into 2008 (for example, Microsoft's takeover bid for Yahoo). Larger clients generally look to larger law firms to provide the required breadth and depth of specialized legal services that they require. They also have need for legal services delivered on the ground in more geographic locations than ever before. Law firms serving these ever-expanding clients find they need to grow dramatically in order to meet those client needs. Firms as large as 400 to 500 lawyers have embarked upon growth strategies focused on merger in order to attain the increased size they believe their expanding corporate clients require. Some mid-sized firms have lost clients to larger firms as corporations decide to "trade up" and employ larger, more geographically diverse and practice-area deeper firms as they grow. Organic growth, through addition of newly qualified associates, and growth by lateral hiring are insufficiently aggressive to achieve the mass necessary to serve corporate clients, themselves rapidly growing, via merger.

Corporate Convergence Movement

Another external factor fueling the consolidation of law firms is the "convergence" movement employed in recent years by corporate law departments, whereby outside legal work is reconsolidated in a smaller number of law firms, thereby facilitating management of outsourced legal work and coincidentally increasing the bargaining power of law departments as buyers. It is not unusual to encounter corporate law departments in the process of reducing their "panel" of outside law firms from hundreds to dozens of law firms. Larger law firms can make the strategic case that they are better able to handle a larger volume of a corporate law department's outsourced legal matters, and likewise if they are capable of providing those services in multiple locations. That (geographical expansion) is another means by which one law firm might be able to replace many. This factor has driven some of the mergers between law firms in diverse geographic location in recent years. Increasingly local firms are becoming regional, regional firms national, and national firms international, and some firms even global in their geographic reach.

Attraction to Lawyers

The increasing sophistication of law students and new law graduates fuels the consolidation as well. These individuals have a surfeit of information available to them through the legal press and through various directory services, as well as law firm websites themselves. League tables published by the legal press and the editorial content of legal periodicals

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Scope mergers involve adding a new practice area or geographic market. Some notable examples:

- DLA (UK) / Piper Rudnick (US) — geographic
- Cooley Godward (CA) / Kronish Lieb (NY) — geographic
- Buchanan Ingersoll ("full service") / Burns Doane (IP) — practice area
- Blank Rome (PA/general practice) / Dyer Ellis (DC, maritime) — combination geographic and practice area

Scale mergers contemplate creation of depth in practice areas and offices to create competitive advantage. Examples:

- Heller Ehrman / Venture Law Group (both CA, IT)
- Seyfarth Shaw / D'Ancona & Pflaum (both Chicago, business practice)

Some are even a combination of scope and scale mergers. Example:

- Pillsbury Winthrop / Shaw Pittman — increase scale in DC to PW, add regulatory and outsourcing practices

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focuses attention on larger law firms. Legal directories that rate the competence or reputations of law firms by practice areas also tend to focus on larger firms. This contributes to creation of "brand name" recognition of major law firms, which is attractive both to clients and to lawyers. Since law firms operate simultaneously in two marketplaces (they are sellers of legal services but also buyers of legal talent), brand name recognition conveys a source of competitive advantage. In the labor marketplace for lawyers, there is a relative finite supply (approximately 40,000 new lawyers per year), and an increasing demand for the best of those 40,000 new lawyers, driven by average new associate classes of 50 or more lawyers annually in just the AmLaw 200 firms. This translates to 10,000 new hires per year, approximately 25% of the graduating law school class. The remainder of the estimated 40,000 law firms in the US can find it increasingly difficult to attract top graduates of top law schools, especially given the starting salary escalation driven by the larger firms whose economics are better able to accommodate those increases. Many small and mid-sized firms have found it virtually impossible to recruit quality law school graduates. This has been a factor that has led some to consider being acquired by a larger firm, as no law firm can succeed or even survive over the intermediate to long term without the continuity of a steady supply of quality new law graduates. ◆

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Ward Bower

Merging Law Firms – Part II

By Ward Bower

Editor's note: This is the second of a two-part article. The first part of the article was published in last month's issue of RTLM (February 2008).

A first, necessary step in considering merger as a route to growth is to develop the fundamentals of a business case for a proposed merger. This would require definition of the characteristics of the required merger partner, in light of the strategic objectives to be achieved. Mergers can be characterized either as those of "scope" or "scale." Scope mergers are those which involve adding a complementary business component to the firm — a new practice area or a new office, for example. Scale mergers are those involved in creating depth in existing locations and practice areas to attract bigger clients and matters or to retain a growing client. The profile of a desired merger candidate would clearly be different depending upon the strategic objective to be achieved.

> "The profile of a desired merger candidate would clearly be different depending upon the strategic objective to be achieved."

Scope Mergers

Scope mergers are those intended to diversify the service offering or client base, or to expand geographically, thereby expanding the scope or range of the firm's activities in some way. Once the profile of a desired merger candidate has been developed (generally it would involve a combination of firm size, practice mix, geographic capability and compatibility factors relating to economics and culture), a preliminary business case for a proposed merger can be developed. It is at this point that contact with the most promising of identified candidates can and should be made.

The initial meeting would involve exploration and articulation of the potential business case for a merger, in order to determine whether there is enough potential to justify further investment of time, energy and money in additional discussions. Generally speaking, the business case for a scope merger would involve a description of the following:

1. Firm A services needed by Firm B clients.
2. Firm B services needed by Firm A clients.
3. New clients that might be attracted by the combination.
4. Firm A clients that might be served in Firm B locations.
5. Firm B clients that might be served in Firm A locations.
6. New locations that might be served by the combined firms.
7. Expense items that might be eliminated by redundancy (accounting, administration, etc.)

From the list above, one would deduct:

1. Clients that would be lost through conflicts.
2. Lawyers (and their practices) that might be lost via merger.
3. Referral sources that might be lost via merger.

The business case for successful scope mergers is usually obvious.

Scale Mergers

Unlike scope mergers, scale mergers are intended not to diversify a firm's service offerings but to deepen those that exist. Although absolute quantification of the components of the scale business case is impossible, some idea might be gained as to whether the positives

outweigh the negatives in such a way as to present greater opportunities for increased profitability in the future than the two firms would be likely to experience separately and independently.

Generally, the scale merger business case would be based upon additional work or matters from existing clients of the two firms that might be gained by the greater critical mass of the resulting firm or greater depth of its specialized practices, plus new clients that might legitimately be attracted as a result of the combination of firms. In scale mergers, redundancy potential generally is greater, especially where integration of offices into consolidated locations occurs — in addition to accounting and administration, redundancies might include receptionists, librarians and research resources, and space devoted to common areas like reception/waiting areas, lunchrooms, possibly even conference rooms. Of course, this needs to be offset by the same negative considerations in potential scope mergers — potential loss of clients, lawyers/practices and/or referral sources, due to the merger. However we reiterate that economies of scale are minimal in the overall assessment of the proposed transaction.

"In scale mergers, redundancy potential generally is greater, especially where integration of offices into consolidated locations occurs..."

Compatibility Factors

Once the fundamentals of the business case are established, consideration should be given to "compatibility factors," which will influence the ability to merge two law firms. Compatibility factors generally fall into one of two categories — economic factors, and cultural factors.

Economic factors involved in compatibility analysis include partner capital accounts, revenues per lawyer, average partner compensation and profits per equity partner. Generally, these factors need to be within a range of 10% to 20% of each other, or it is unlikely that a successful merger will occur.

Cultural factors include such issues as expected time commitment to firm and clients, the balance between centralized firm authority and individual partner autonomy, methods for selecting/changing leadership, methods for determining partner compensation/profit distribution, methods and levels of capitalization (including debt and attitudes toward the use of debt financing), existence and amounts of unfunded obligations to retired or departed partners, and leverage ratios of associates to partners and paralegals to lawyers.

Once there is general agreement with respect to these issues, three specific economic issues need to be resolved:

1. ***Equity equalization,*** in order to bring capital accounts (or stock ownership/valuation) into rational balance between the owners of the two firms. In some cases this will involve an up-front payment by one firm to another, which can be financed either out of current partner earnings in the other firm, or by use of a source of financing, such as bank debt. In other instances, capital contributions might be made by members of one firm over time, until parity is achieved in the capitalization scheme agreed to as part of the merger.
2. ***Compensation slotting*** should also occur, so that it is clear where compensation of all partners will fall within the scheme adopted as a term in the merger agreement — whether it be the compensation scheme of one of the two firms, or an entirely new scheme developed as part of the merger negotiation.
3. ***Equity/non-equity partners.*** Most firms today (80% of AmLaw 100) have tiers of partners, with different criteria for admission and advancement to "equity" status. Ten years ago less than half of AmLaw firms made such distinctions. Prospective mergers need to consider status of partners, equity vs. non-equity, in the merged firm. It is not unusual for this issue to scuttle an otherwise appealing (e.g., positive business case) merger scenario, due in many cases to the supermajority vote of equity partners required to approve a merger. It is hard to get the turkeys to vote for Thanksgiving.

Negotiation Items

Negotiations need to address the fundamental issues that will effectuate the business case driving the rationale for the merger. They also need to address the economic and cultural issues identified in the preceding section. They also need to address critical elements of the resulting firm — equity/capitalization schemes and levels, compensation methodology and slotting, handling of any unfunded obligations and survival/reduction/elimination of those obligations, firm name, management structure and individuals to fill various roles and positions, transition arrangements — teams, events, etc., and other factors unique to every

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deal — office locations, openings, closings, new positions to be created, and in some cases anticipated future mergers to attain an agreed strategic vision.

The negotiation position taken will depend upon the relative size/influence of the two parties involved. Where the size/economic leverage differential between parties is 50% or more, generally the stronger of the two firms will dictate most of the provisions. The primary decision to be made by the less powerful of the two firms is essentially "can/do we want to become part of that firm?"

Where parties are closer in size, then the only realistic approach is to view the merged entity as a third firm, separate and different from either of the two legacy firms. In such case, each element of the resulting firm needs to be discussed in some detail, and consideration needs to be given to best practices in either of the two legacy firms or in possibly creating a new approach different from that in either of the two firms. This often happens with respect to capitalization, compensation schemes, management structures, and retirement policies/arrangements.

Due Diligence

At the point at which it appears that negotiations are proceeding on track toward development of a term sheet or prospectus documenting the understanding of the two parties to the merger, due diligence should be conducted. Generally this involves "opening the kimonos" of each firm for reassurance that negotiations have been open, honest and conducted with honesty and integrity. Fundamentally, due diligence is viewed as a financial issue — that is, examining the books of the other party to verify income, expenses, client base, sources and uses of capital, benefit plans, retirement plans, and the like. In some cases this will involve use of outside agents such as the firms' accountants, to conduct the process. In addition, *legal* due diligence needs to occur which would include evaluation of risk factors such as potential client conflicts, outstanding or possible future professional or general liability claims against the firm, insurance coverages, vendor or landlord disputes, lease arrangements, and other legal and risk management issues.

Term Sheet

After both firms are satisfied that their due diligence has been completed, the next step is to draft a term sheet outlining the arrangements under which the merger will occur — capital structure and any equity equalization payments, how debt will be handled, structure of the new entity, ownership of the new entity, handling of intangible assets such as accounts receivable and work-in-process, leasehold arrangements, unfunded obligations, compensation structures, benefit programs and retirement plans, firm name, and management structure and position appointments.

Since partnership agreements in law firms generally require a vote of partners (in most cases a supermajority) to approve a merger, the term sheet is often used as the basis upon which votes will be sought. In other instances firms will go so far as to prepare a corporate merger-style prospectus outlining the fundamental attributes of each of the legacy firms, the business case for the merger, and the vision of the merged entity in terms of consolidated financial statements and client bases, market position and benefits to be derived from the merger.

Preparation for a merger vote begins well in advance with an educational effort to advise owners of each of the firms of the strategic rationale, reasons for selection of the merger partner, basics of the business case, likely components/attributes of the merged entity, advantages (and possible disadvantages) to individual partners or groups, and the like. As momentum builds toward the vote, opportunities need to be found for introduction of leadership of each of the two firms to each other and, if possible, personal interaction between all of the owners of each of the two firms, probably in a combination of formal (meeting) and informal (social) settings.

Integration Plans

Finally, merger integration plans should be developed, at least in outline form, prior to the merger vote. Some firms will append them to the prospectus, submitted to partners, pre-vote, where that methodology is used.

Scope mergers involve adding a new practice area or geographic market. Some notable examples:

- DLA (UK) / Piper Rudnick (US) — geographic
- Cooley Godward (CA) / Kronish Lieb (NY) — geographic
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Some are even a combination of scope and scale mergers. Example:

- Pillsbury Winthrop / Shaw Pittman — increase scale in DC to PW, add regulatory and outsourcing practice

Integration plans should address the following:

1. financial integration and financial management
2. HR integration and management
3. IT integration and management
4. marketing integration and management, including the initial marketing and public relations plan for the merger
5. practice management integration
6. administrative integration
7. office space integration

Prospects for Success

The question often asked is "how many of these increasing numbers of law firm mergers are successful?" In 2007 Altman Weil studied the 117 law firm mergers that occurred between 2000 and 2005 where at least one of the parties was an AmLaw 200 firm. The study revealed that:

- The vast majority of large law firm mergers have resulted in increased profits per partner from year one on (77%).
- Year on year profitability shows ever larger percentages of merged firms showing an increase from the year prior, to 94% of firms by the fourth year.
- Merged firms overall showed greater post-merger increases in profitability vs. the AmLaw 200 overall, a cumulative 53.5% increase vs. 44.2% for the AmLaw 200 over the period 2000 through 2005.

Final Thoughts

Law firm mergers are always consensual, in the sense they can be executed only if owners of both firms agree. There technically is no such thing as a hostile takeover of a law firm. And, because law firm owners are also managers and producers of the business, there must be broad consensus to make a merger occur. Since lawyers generally are independent thinkers and competitive individuals, a decision to merge with another entity owned by other independent thinking, competitive individuals is not made easily. Therefore, the business case for the merger of firms must be compelling, effectively articulated and communicated broadly within both ownership groups.

There have been some notable law firm merger disasters (Rubin and Proctor / Isham Lincoln & Beal comes to mind). However, preliminary studies have shown the vast majority of law firm mergers of significance have proven to be successful, at least as measured by incremental profitability. There is no reason to conclude that the current merger trend will abate, and many reasons to predict that it will continue as the factors driving it persist. ◆

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