

November, 2013

MERGERS ARE ON THE RISE AGAIN BUT PAY ATTENTION TO THE RED FLAGS

As reported in the Wall Street Journal, October 28, “Merger talks between major law firms are heating up this fall.” This is not surprising. Mergers have always been a prime strategy for certain firms. Now, as major clients continue to cut their legal budgets and alternative service providers continue to proliferate, mergers have become even more prevalent in today’s tough level market.

Firms can no longer count on an expanding legal market for growth. This means they must obtain a larger share of a flat or even shrinking market by obtaining business from other firms. And one way to obtain this business is by merging in, *i.e., acquiring*, other firms or at least entire practice groups.

Yet a look at history reveals that about 50% of all mergers subsequently fail. In many cases the reason(s) for the eventual failures were issues that were evident beforehand and should have raised red flags about proceeding with the merger. On the other hand, when firms end merger discussions, whether the potential merger had been announced or not, it is often only after they have spent an undue amount of time trying to resolve red flag issues and finally decided they couldn’t.

We describe these as “red flag issues” because they are extremely difficult and, in most cases, are issues that can never be resolved. These are the red flags that arise most often.

- Although they have agreed to seriously consider merging, one or both of the firms does not make it a high priority item, dragging their due diligence or the discussions on for an extended period of time.
- A major client that represents a significant amount of the revenues – and also probably the profits – of one of the firms announces it is taking its business to another firm.
- There are wide differences in the partner incomes between the firms.
- The firms have different work ethics as indicated by wide differences in average billable hours.
- The acquiring firm requires partners to buy-in and contribute capital while the firm being acquired does not.
- One of the firms has a substantial amount of debt while the other firm is debt free.
- One firm has an unfunded pension liability and the other firm does not.
- The practices do not fit. An example from two litigation firms: One firm’s practice consisted mainly of major, “bet the company” cases for large corporations. The other firm’s practice was largely commodity litigation with a high percentage of insurance work at far lower hourly rates.
- Conflicts. Legal conflicts can usually be identified and possibly resolved. However, there can also be business conflicts such as when a major client of one firm says it will withdraw all its work because a major competitor is a client of the other firm.

- A major producer in one firm opposes the merger and threatens to leave, taking his/her clients and even an entire practice group.
- Different compensation systems. Partner compensation in one firm is based on billable hours or collections while, in the other firm, partners are compensated mainly on origination, regardless of billable hours or responsible partner collections. Another example: One firm has a formulaic system while the other firm subjectively evaluates partner performance based on published criteria.
- “Unproductive partners” whose billable hours or collections are far below those of the other partners in either firm. However, their firm wants them to be partners in the new firm, or at least be included in the firm, while the other firm does not.
- Management in one or both of the firms has not informed the other partners that it is in the process of negotiating a merger. Then, with little notice or time for discussion, presents the merger to the partnership for approval.
- The name of the new firm. This has been the “deal breaker” in a surprising number of potential mergers that were called off. When a smaller firm is merging into a much larger one, this is rarely an issue because the larger firm’s name will usually survive. However, when it would be a so-called “merger of equals”, this issue often becomes extremely sensitive because both firms want their firm’s name to survive in whole or in part.
- But the first red flag that can appear is when the firms are drafting the confidentiality agreement before any information is exchanged. This document should include a stipulation that, if the merger does not occur, neither firm will attempt to recruit lawyers from the other for a specified period, usually one year. This is often referred to as a “cherry-picking clause”. If either or both firms are unwilling to agree to this, that should raise a huge red flag that the merger, if it eventually did occur, would sooner or later fail.

Negotiating a merger is a complex and delicate process. However, there would be fewer failed mergers, or considerably less time and resources spent on potential mergers that do not occur, if firms recognized and addressed the red flags when they arise.

To paraphrase the old adage: “Look long and hard before you leap.”

Note: For a comprehensive discussion of the merger process, visit our web site www.robertdenney.com, and click on the article, “A Primer on Law Firm Mergers”.

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