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LAW FIRM CONSULTANTS

DISPATCHES FROM THE MERGER FRONT

John S. Smock, Partner
Smock•Sterling Strategic Management Consultants

In spite of a commercial merger and acquisition market that has fallen off a very high cliff, 2002 was a banner year for law firm mergers and combinations continue on.

Like most consulting firms serving the legal marketplace, Smock Law Frim Consultants has been heavily involved in merger/combination consultation. In fact, merger advice constituted approximately 35% of our 2002 law firm practice. While we are grateful for our clients' confidence and believe we have helped our clients both to prepare to merge and to integrate after a merger, at times we shake our heads at the irrationality of what goes on in the law firm marketplace.

Law firm mergers – the way they are approached, considered, effected, and integrated – as well as the expectations and beliefs of law firm management, their partners, and the consultants that serve them often take on an aura resembling Lewis Carroll's *Alice in Wonderland*. The purpose of this monograph is to address those issues in a manner similar to a war correspondent – these are my dispatches from the merger front.

WELCOME TO THE LAND OF UNREALISTIC EXPECTATIONS

As wise and worldly as good attorneys are in advising their clients in complicated business deals, they often take leave of common sense (and their own advice) when considering or effecting a law firm merger. Law firm managements and their partners' often approach merger possibilities (and integration of the merger after one is agreed to) with unrealistic expectations. Some common examples follow.

> ***"A big national firm will acquire us and we will make $1,000,000 or better a year"*** – heard from firms (often very, very good ones) in markets smaller than New York, Los Angeles/San Francisco, Washington DC, and Chicago and based on the erroneous assumption that national firms are looking to expand in non-major markets and are willing to take profits out of their present partners' pockets to pay the partners of a new merger partner – **it just is not going to happen, as national firms are generally not looking to expand in non-major markets and they will not dilute their partners income to give merged partners' incomes a dramatic raise.**
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> ***"We want to be in control of any merger, so we will only merge with smaller high quality firms"*** – based on the erroneous assumption that there is an infinite number of smaller, high quality firms with similar partner incomes and client bases anxious to merge with a larger firm and give up their independence and autonomy – **while there are still a few of these firms out there, they are few and far between and they often have little desire to join a larger organization.**
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> ***"We will get lots of work from our merger partner's clients"*** – a remark we hear often while merger potential is being discussed, but seldom see happen in real life, as most mergers are short on effective integration and, unfortunately, there is very little introduction of new merged firm resources to present client bases – **it will not happen unless the merged firm is restructured (on a practice-by-practice basis); cross marketing efforts are specifically planned, executed, and measured; and partners are specifically rewarded for doing it.**

"If we merge, we will get better, more profitable work from bigger, more prestigious clients" – part of the erroneous assumption that all firms can move up the *"food chain"* at will and a larger firm, because it is larger, is in line for more profitable work – **a merged firm will not get more work from more prestigious clients unless they demonstrate improved value and/or capability to those clients or potential clients – this requires effective integration and solid marketing of the *"new firm's"* capabilities.**

MERGERS ARE BUSINESS ISSUES AND MUST BE MANAGED AS SUCH

One of the major limitations to effective law firm mergers is the unwillingness or inability of law firm leaders to manage the process as a high priority business issue. Generally the merger process is riddled with delays, a general inability to make decisions (to go forward or not), and a distinct lack of management courage (i.e. – to take on the obstructive gorillas, to decide on potential practice leaders, etc.). We see problems in two key areas.

Inability to Identify and Move Forward with Potential Targets

There is considerable delay and an accompanying lack of timely decisions in the *"courting process"* of identifying, contacting, and discussing merger possibilities.

- Since most discussions never get to the fruition stage, this courting process takes entirely too long and consumes an inordinate amount of resources. Even when there is interest on both sides, setting up a single meeting to really get serious can take months.
- Everything is done in *"series"* – virtually nothing is done in *"parallel."* Each meeting determines the next steps and deadlines are seldom set for key decisions.
- Often no one is in charge of managing the process or moving it along. If left only in the hands of the two firms' CEOs, merger discussions usually come behind other priorities and the process just drags and drags.
- We continually hear the excuse that a firm needs to wait until it takes care of its internal issues. In truth, no firm ever gets all of its internal issues behind it. If a firm feels it should talk, it should talk. The fact that it has internal issues to deal with is a given – everyone does.
- Potential deal breakers (the name, how the new firm will be governed, who will manage the major practices, unfunded liabilities, etc.) are not dealt with early or forthrightly enough.
- The focus of the discussion between the two firms is almost entirely internal. They spend very little time identifying, defining, and quantifying true synergies (yet, no merger is effective unless and until real synergies kick in). Also, there is little effort placed in determining the new firm's vision and strategy – what *"new firm"* will be and what it will do.
- Very little time is spent *"selling"* the merits of the merger to key partners and practices, in both firms, yet those key partners and practices are often the greatest obstacles.
- Many law firm CEOs open merger discussions with other firms without what we call a *"pocket proxy"* (i.e. – a general agreement among the partners as to the potential value of a merger and the criteria for a potential partner). Thus, they are forever hanging out on a limb, not knowing whether or not their partners will support a reasonable deal.

Inability to Integrate After the Merger

While the above *"mistakes"* in the courting process are troublesome, they are not fatal. But, an inability to effectively integrate after a merger can be and often is fatal. The biggest problems/drawbacks we see include:

- **Co-CEOs** – where the CEOs of the two merged firms share the CEO title and responsibility for an unspecified time after the merger – folks, it does not work in industry (think Weill and Reed at Citigroup and numerous other examples) and it does not work in law firms.
- **Co-practice heads** – essentially the same problem as the co-CEO one, but it is potentially even more damaging as it results in no integration within practices (the old firms' practices stay in place) – thus, no synergy.

- **Fear of losing people** – new firm management defers reasonable integration or restructuring steps because of the fear that people might leave – but, all mergers (both good and bad) will result in some losses – this is not necessarily a bad thing and no partner or group should hold the new firm hostage via a threat to leave.

- **Lack of management courage** – an inability to make the tough decisions that come with any merger – the above problems can all be addressed by courageous management – in fact, a merger will not work without it.

IT IS A NEW FIRM, DARN IT, NOT A COMBINATION OF TWO FORMER FIRMS

Directly related to the integration issues mentioned above is the general reluctance of merged firms to quickly discard who and what they were and become the *"new firm."*

- It starts in the merger discussion stage. Little focus is placed on what the new firm will be, what advantages it can bring to the market, and, importantly, what synergies it can achieve.

- It blossoms as a problem after closing. The new firm is seldom referred to – people talk about the old firms and what they did, rather than the new firm and what it will do. They defend their old firms' systems, organization, and culture – all at the expense of the new firm. There is very little real excitement about the new firm and what it can be.

- But, it is the new firm that will make the merger work. **It is what you become, not what you have been that creates added value**. Also, focusing on new firm gives everyone an opportunity – a fresh start, if you will – to do things right (there are no excuses).

"YESTERDAY I COULD NOT EVEN SPELL INVESTMENT BANKER, TODAY I ARE ONE"

It is not fair to only criticize law firm managements' actions in law firm mergers – the law firm consultants often are part of the problem, not the solution. Some of our primary concerns with what the consultants are doing follow.

- First, the thirst for a *"success fee"* seems to have blinded some consultants and their firms to the requirement to provide practical, conflict free, and client focused advice. This thirst has led many consultants, as it has before with investment bankers, to miss the key point that they are there to serve the best interests of their clients, not to promote a deal merely to collect a fee.

- Some consultants are actively introducing their clients to their other clients (rather than to firms who best fit the agreed upon criteria), similar to the real estate broker who attempts to represent both the seller and the buyer to double the fee. Again, the legitimate question comes up – who are they there to serve?

- Other consultants are putting a new wrinkle into milking the merger process – not only maneuvering for a success fee, but also charging target firms a fee for introducing them to the primary clients they are serving (under the *"heads I win, tails you lose"* principle).

- Investment bankers were able to get away with this behavior (although not anymore), because they could take their fee (deserved or not) out of the proceeds of the deal. But, in virtually all law firm mergers (as opposed to any other market segment, including other professional services) no money passes hands – these are non-cash deals and there is no *"pot"* from which to pay success fees.

Our advice is that if your consultant wants a success fee, dismiss him/her. Consultants' rates (ours and our competitors') are certainly high enough to provide a fair return for assistance in mergers. Management consultants can play a very important and valuable role in the law firm merger process, but that role is based on experienced management counsel, not on behaving as an investment banker or real estate broker.

AVERAGE PARTNER INCOME IS JUST A STATISTIC

There is a general belief (which has become close to gospel) that two law firms should not merge unless their average per partner income is about the same. We could not disagree more.

- Average per partner income is a statistic – only that. While it certainly can reflect an improvement in performance (or lack thereof), it can also directly reflect purely statistical events (e.g. – an increase in the number of partners due to deserved promotion, reclassifying or de-equitizing partners, etc.). Thus, looking at this one statistic as the prime indicator of a target's potential can lead to faulty (and, possibly, fatal) conclusions.

- In looking at a merger partner, it is critical to look beyond that statistic to important basics such as the distribution of partner income (who gets paid what and why), the partner income determination process, how income is distributed (e.g. – out of available cash, use of a line of credit, etc.), and the relative size and definition of the equity and income partner groups.

- There is no question that some AM Law 100 and AM Law 200 firms manipulate the inputs to the average per partner income statistic – merely to look better in the once a year comparisons in the American Lawyer. Often, a very good result (i.e. – a very high number) may indicate that a potential partner has *"fudged"* the statistics and may not be the type of merger partner originally desired.

We believe that a difference in average per partner income between firms should not be (a priori) a significant obstacle to a successful merger.

- There are a variety of tools to deal with an imbalance in partner income – separate compensation pools, reclassification of equity and income partners, etc. – that can ensure there is not dilution of income for producing partners (in both firms).

- Also, I personally would not want to merge with a firm that has maxed out its partner income potential (and a number already have maxed out and are living on the *"billable hour hamster track"*) – rather, a legitimate opportunity to grow partner income is a positive indicator of potential synergies and gives the new firm *"breathing room."*

- Partner income is an effect – not a cause. Rather, the issue is *"new firm"* and what strategic benefits it brings to the merging firms, including ultimate partner income increases.

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Smock Law Firm Consultants is a smaller, focused management consulting firm serving a variety of leading law firms nationwide. In addition to extensive merger and combination assistance (in all four stages/phases of a merger – dating, courting, the wedding, and the marriage), we also are recognized for our skill in strategic planning (at the firm and practice levels), practice group management, law firm profitability, and strategic management issue resolution.