SMOCK

LAW FIRM CONSULTANTS

TO MERGE OR NOT TO MERGE? – THAT IS STILL THE QUESTION

John S. Smock, Partner
Peter A. Giuliani, Partner
Gary B. Fiebert, Partner
Joseph V. Walker, Partner

Our partner, John Smock, penned a monograph a number of years ago entitled "*To Merge or Not to Merge? – That Is the Question*." It was based on our firm's prior and continuing experience in law firm mergers and our opinions – at that time – on the merger/combination process, what was working, where we thought consultants were adding (and not adding) value, and our suggestions for making the combination process more successful. While a good bit of merger water has since flowed under the dam, the topic of law firm mergers and combinations remains the most covered topic in the legal management media. Many more firms have considered combination as a viable strategy, a good number have done it, and even more have had discussions with other firms considering potential mergers. We felt that the large amount of water that has flowed under the dam justifies another look at and an updating of our thoughts on law firm combinations – thus, this monograph.

This monograph contains a present day overview of law firm mergers and combinations (i.e. – what is happening out there), what is generally working, what is not, and Smock Law Firm Consultants' (SLFC) general merger/combination suggestions to the legal marketplace.

We should note that SLFC is not trying to use this monograph to say everything that can be said about law firm mergers and combinations. Books have been written on the topic and this is clearly not a book. This is also not a *"how to do a merger"* article, but more one that focuses on *"how to think about a law firm merger."* We are trying to provide some insight to what is going on and to what could/should be done about it.

Law Firm Mergers/Combinations in Late 2015 – An Overview

Unless something unusual happens (like a full stock market crash), 2015 will turn out to be the most significant law firm merger/combination year in legal management history.

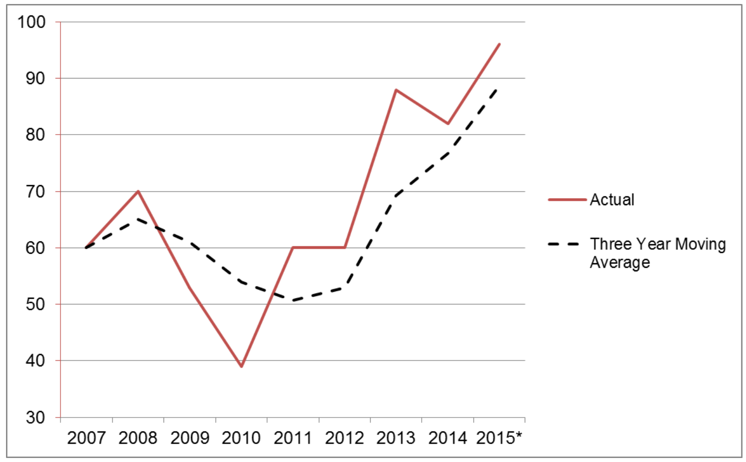
- Through the first six months of 2015, the Altman Weil MergerLine has recorded 48 mergers, the highest half year total in the history of MergerLine, their law firm merger/combination tracker.

- And, those are just the merger/combination announcements – we know from our own merger consultations for clients that there are a significant amount of merger discussions going on and a wide range of firms are looking for the perfect merger partner. It is true that most mergers remain as actual acquisitions of smaller firms by larger firm (more than 90% of the smaller firms in a merger are under 50 attorneys – year in and year out). And, significantly increased combination discussions are underway across the full size spectrum of law firms, from the largest to the smallest.

Following are a summary of law firm mergers and combinations for the last nine years (the full period that they have been tracked), as well as a graph showing the number of mergers each year and a three year moving average (to smooth out annual variability).

Law Firm Mergers & Acquisitions		
Year	**Total**	**Three Year Average (from 2007 on)**
2007	60	60.0
2008	70	65.0
2009	53	61.0
2010	39	54.0
2011	60	50.7
2012	60	53.0
2013	88	69.3
2014	82	76.7
2015	96*	88.7

through 6/30/15 there have been 48 mergers, which we have annualized as 96 mergers, although we believe there will be more
Source: Altman Weil MergerLine



There are a whole host of reasons for these mergers, combinations, and acquisitions – some unique to specific transactions and others reflecting trends in the overall legal marketplace. We believe that now the most important reason to merge is that in this multi-year period of essentially flat demand for legal services, well executed combinations remain clearly the most effective (and, possibly, the only) way to grow a law firm and its important practices. Relying on *"bringing in laterals with books of business"* has just not worked as a growth strategy. And, well done mergers are not only the most effective way to grow, but also comparably and dramatically, are less expensive per attorney than bringing in individual laterals or groups of laterals.

- In the broader business and professional marketplace beyond law firms, mergers and acquisitions are also a very good way to grow, but they are generally quite costly. For instance, a number of years ago, when American Express, H&R Block, and Century Business Services were acquiring hundreds of smaller accounting firms, they were using a formula to pay for those firms' practices – there was a real purchase price. So, there was a capital cost that had to be factored into the expected rate of return.

- But, most law firm mergers are structurally different. While there definitely are significant hard and soft costs to a merger, most law firm mergers are accomplished by a pooling of the two firms' assets (and liabilities). Simply put, the acquiring firm (or the *"new firm"* in a true merger) is not paying an upfront purchase amount (based on a share price) for the practices of the joining attorneys. That lowers the financial hurdles, raises the probability of success, and probably increases the risk.

In addition to the above primary reason, all of the other reasons generally agreed upon for law firm mergers and combinations remain (including a perceived or client requested need for more depth, breadth, and geographic platform; globalization; to achieve an improved competitive position; lack of sufficient successors for practices and clients; and, honestly, a desire to follow the herd, as in *"everyone else is merging, so should we"*). We need to add another one. We believe that the incidence of law firms who have looked into their crystal balls and do not like what they see has increased. They have not dealt with the long term issues of both a lack of effective succession planning and underperforming partners. There are more and more law firms (of all sizes, but lots and lots of smaller litigation firms) that see a less than promising future and are now actively looking for *"any port in a storm."* These firms, particularly many of the smaller litigation firms, appear to be looking for more of a savior than a merger partner to grow with.

We also need to clarify some differences in the structure of law firm mergers and combinations – they are not all the same. We see three types mergers and combinations (with a good bit of variation).

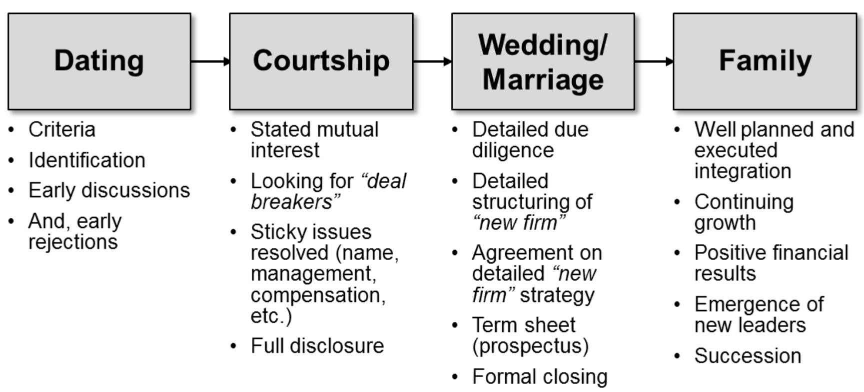
- The first is **the acquisition of a smaller firm by a larger firm** and where, in most cases, the firm name remains the same and the larger firm's management is responsible for the acquired firm and integrates it into the existing larger firm. This category makes up a clear majority of all law firm mergers and combinations – year in and year out.

- The second is **the true merger**, where two firms, of reasonably similar size, combine to create a ***"new firm"*** where the new firm's strategy, management, systems, and a variety of other factors build on both legacy firms and the name of the firm is almost always a combination of the two firm's names.

- The third type of law firm merger/combination is **the hybrid**, where the resulting firm is somewhat an acquisition and somewhat a true merger. An example might be a 100 lawyer firm that merges with a very capable 30 lawyer firm, the two share the new name, and there is a greater allowance for the 30 lawyer firm in management roles, governance, and systems that would normally be called for with the size differential.

All three of these examples are considered mergers and are counted as one merger. Denton's merger with the 3,881 attorney Chinese law firm Dacheng Law Offices (announced but not yet completed) is considered to be a single merger, as would be a merger of a five lawyer litigation firm in DesMoines with a five lawyer business firm in Cedar Rapids.

Finally, doing a law firm merger (as any business to business merger) is a difficult, time-consuming process. While there are costs to doing this, the most precious commodity invested – by both firms – is the time of the key people to pursue merger targets, accomplish due diligence, close the deals, and integrate the two firms. And while every merger is different, we have found that a law firm merger (particularly because of the emotion involved, as compared to a business merger) can be compared to a *"marriage"* with its four stage components as shown following.



<u>What Works in Law Firm Mergers/Combinations?</u>

The factors that we see working – on a relatively universal level – in and around law firm mergers and combinations follow.

- While there are some law firm mergers that have not worked (and some spectacularly), most law firm mergers are considered to be reasonably to spectacularly successful. Surveys have shown that – for the majority of law firm mergers – desired objectives have been achieved, income has gone up, and the combined firm has operated in a dramatically different competitive position. So the concept had clearly proved itself.

- Those firms that have done and are doing it right have virtually all developed a deliberative, expeditious, and comprehensive process (for identifying and considering potential partners in executing actual mergers/combinations) that responds directly to a firm's overall strategy and is effectively managed and directed. Such a process is an active one and requires action – sitting around waiting for the phone to ring from the perfect suitor will not get it done.

- Essential to beginning this process is the development and adherence to a set of specific criteria for merger partners – that, while somewhat flexible (but not too much so) – enables relatively easy initial analysis and ranking of potential merger partners.

- Once a target has been identified and has responded positively, the merger consideration process must move along with dispatch. In other words, the *"go/no go"* must be accomplished quickly, so that time and effort is not wasted on merger that just will not work (and many of them will not).

- Experience (as in *"learning curve"*) is important. Law firms and their managers learn from the courtships that do not work out – what to do, how and how quickly to do it, what information is valuable (and what is less so). Also, the larger firms who have done a number of successful mergers (e.g. – Reed Smith, Nixon Peabody, etc.) have become very, very good at it – when an opportunity presents itself, they can react and execute a merger quickly and effectively.

- Those things or issues that have a greater probability to *"sink the ship"* need to be addressed as soon as possible in the process. Both firms need to know and agree on the new firm name, who will lead the new firm, how the new firm will be governed, how each firm's balance sheet will affect the combined balance sheet (and what this means in terms of potential capital requirements), whether or not there are major conflicts (either with clients or within new firm, such as one firm suing insurance companies and the other defending them), how the partners will be paid, and whether or not the two cultures and sets of core values are complementary or opposing.

- Whatever is done to ultimately affect the merger (identification of targets, negotiations, agreement and closing, and integration) needs to be done expeditiously. We have seen potentially very, very good strategic mergers die essentially of their own weight, because neither party is able to get done what needs to be done in a reasonable amount of time.

- Also early on, a comprehensive business strategy for new firm has to be decided on. Most of the due diligence and negotiation time is usually spent on internal things (governance, partner compensation, etc.), the success of the merger will depend primarily on how well the new firm performs in the marketplace and that will depend on the effectiveness of the overall direction of new firm, the strategies undertaken to get there, new firm's revised market position, and the degree of *"buy-in"* and commitment shown by new firm's partners.

- While certainly more impactful to a true merger, a principle that really affects all combinations is the idea that all concerned need to be thinking of what *"new firm"* will be from day one. That is why getting the new firm name and firm structure behind the negotiators is very important, so that the name of the new firm is used in all the discussions rather than just the names of the legacy firms.

- Either the managing partner or the partner/partners leading the merger consideration process, should preferably have a *"pocket proxy"* from their partners (or, certainly, their key partners) to seriously consider a merger. It is not a blanket approval, but the *"pocket proxy"* enables that partner or partners to not get too far out ahead of the thought process of the partnership itself. It does not guarantee approval, but it clearly helps avoid failure (because most partners base their votes on the specifics of *"what this will do for me"*).

- We mentioned earlier that the clear majority of mergers/combinations are, in fact, acquisitions by a larger firm of a smaller firm. But we have also seen that, regardless of the nature of the transaction, the more successful combinations are those where the acquiring firm treats the acquired firm as if it really were a true merger, rather than shoving all the rules and regulations of the larger firm immediately down the throat of the acquired firm.

- Another success factor is recognition on the part of those seriously trying to affect the merger or combination that the odds are against success even in a potential merger that looks very good from day one. They are just a very large number of hurdles to get over and the probability of getting over all of them is not good. When a firm decides that a merger is part of its strategy, then it needs to recognize that it will probably have some false starts before a desired merger is achieved.

- The importance of technology is critical in combining the firms, serving new firm's clients, enabling the attorneys to practice law, and a variety of other factors. It is one of those upfront considerations that need to be addressed early in the process. Addressing the wide range of technology issues effectively is part and parcel of a successful merger.

- Important to a merger is *"applied political science,"* as even the best designed merger needs to be approved by the owners of both firms. It does not happen automatically and those who put the merger together need to make sure – ahead of time – that the vote will be positive.

<u>What Does Not Work?</u>

Following are those activities or approaches that we have found clearly do not work in successfully merging or combining law firms.

- There is often the assumption that the primary reason to accomplish a law firm combination or merger is to achieve economies of scale – but, that is virtually never the primary reason why two firms should merge. There are some minor economies of scale in a merger, but never enough to justify it. The argument for new firm has to be based on the strategies that will be undertaken, the combination of the practices, the synergies to be achieved, and expanded work for present and new clients. Yes, two firms do merge for financial reasons (as well is strategic ones), but the financial benefit does not come from saving costs, it comes from growing profitable revenue and expanding client relationships.

- As discussed in the *"what works"* section, not addressing potential deal breakers early on is often the most critical mistake made in merger negotiations. Those key things need to be addressed early and, as Roseanne Rosannadanna always said, *"there is always something."*

- Doing each step in the process of considering merger in a series (i.e. – first step one, then step two, etc.), rather than doing tasks in parallel is all too often the reason for even a very logical and strategic merger to stall and die of its own weight, before it ever gets done. There has to be delegation of responsibility, a variety of tasks can be done by others, and management of the overall process. It is not a one woman/man show for either firm.

- We often hear firms say *"we are interested in doing a merger, but we need to get our act together first – there are lots of things that need to be corrected or fixed before we can merge."* Often there are some things that do need to be done before merger can be considered, but more often the not, that is an overstatement. There is virtually no way all firm warts can be removed (from both sides) prior to the merger. We know of firms that have been waiting for years to get their acts together and are still not there.

- More often than not, the focus is much too internal. People negotiating the merger may spend an inordinate amount of time comparing partner compensation and very little time on how to integrate client service and practices, where the rubber really meets the road and the value of the merger lies.

- All too often, we see law firm merger negotiations as being an exercise in proving that one of the legacy firms does things much better than the other legacy firm (as in, *"we are better than you are"*). There are long explanations of why a firm does something one way and why new firm has to do it their way in order to be effective. Simply put, it is a waste of time for both firms to try to *"win the negotiations,"* as the two firms will have to live with each other. *"Winning"* often creates resentment and the need for the other side – in the future – to even things up (as it often does). In truth, the examples of this unnecessary desire to win negotiations are quite humorous (and we have seen some doozies) – but, they are also dangerous to the potential for new firm and will cost everyone money.

- Often, the due diligence, negotiations, and closing go quite well, but the merger integration is a train wreck. Too often there are no effective integration plans, no assigned responsibility, and no deadlines. There are two major effects from a poor integration process – the merger does not achieve its financial/professional potential and people leave (often in very large numbers).

Smock Law Firm Consultants' Suggestions

Following are SLFC's suggestions for successful mergers/combinations. They may fit a reader's firm's conditions or they may not (when it comes to mergers and combinations, each firm possesses a different set of circumstances). But, we believe that they should fit most firms, as firms address their strategic growth needs, requirements, and unique situations.

- A good place to start is having an externally focused meaningful strategic direction. While it is true that by now most midsize and larger firms have what they call a formal strategic plan. But in many firms, that plan often provides very little insight as to what the real strategic direction of the firm is or should be. Often, that plan is really a listing of internal action steps. So, we suggest that – first – firms look at their strategic plan and answer the question whether or not accomplishing a merger makes sense as a strategy to achieve their stated strategic direction. If it does, then seriously consider a merger/ combination process – if it does not, then do not pursue such a process.

- More often than not, most law firms' strategic direction calls for growth (something these firms are having trouble achieving) with the primary way to get to that growth being the standard strategy of *"recruiting laterals with books of business."* Many firms (even those with very good lateral recruiting processes – by the way, a very distinct minority) have recognized that it is very difficult, if not impossible, to grow a firm through a primary focus on lateral recruiting. In truth, the best (and, perhaps, only) way in the present and expected legal marketplace to grow a law firm is through a well thought out merger or mergers. So our advice to any firm wanting to grow (where that growth is a primary goal of the firm) is to begin the process of researching and seeking out merger partners in an effective and focused way.

- A merger (or mergers) is not the only strategic approach a firm can take. If everyone is looking to merge, then a very good differentiation strategy is to not merge. And, firms can be very successful by running counter to the overall trend – but, it is not easy. We believe that a strategy of not merging is just as difficult to implement as a strategy to merge. It requires, in most cases, a law firm to really improve its competitiveness – across the board – so that it can compete with merged firms. That implies better organization and focus to its practices, ensuring that all partners are carrying their load, and managing the firm to make a comparable profit to competing firms who grow through merger – all easier said than done.

- Whatever a firm decides to do (such as actively looking for merger partner, just setting the criteria to evaluate calls, or clearly carrying out a strategy of not merging), it must be *"in control of its own destiny."* An active strategy is virtually always clearly preferable to a passive one. Waiting for the phone to ring is not a winning strategy.

- It is important to set potential merger partner criteria, even if a firm is not actively pursuing a combination. We strongly suggest that firms go through the exercise (it is actually pretty darn easy) of actually setting the criteria for a potential merger.

- As much as a firm or both firms possibly can, it/they need to keep those partners who think of themselves first (and boy, have we seen a lot of them) out of the merger process. They skew everything they possibly can to expanding and/or preserving their own personal benefit, put obstacles in the way of anything that they think is not directly beneficial to them, tick off the partners from the other firm, sow distrust among their own partners (which can result in a good deal being killed), and contribute little value to creating a new firm.

- If a firm is going to undertake an active search for merger candidates, it needs to assign responsibility for doing it. Yes, the Managing Partner should be involved, but we suggest – more often than not – that there be a small group within a firm that works together and delegates responsibility within that group for various activities. There is a real myth in the outside business community that CEOs *"do deals."* But, most day-to-day work and direction on mergers and acquisitions consists of delegated activities (even Donald Trump in his omniscience does not do the scud work of his deals).

- A rational, well designed, and focused due diligence process is essential. Do not get buried up in the weeds – but, also do not pass over key items (such as the need to merge balance sheets). Develop a due diligence check list, gain agreement from both sides, and execute it according to plan.

- As discussed earlier, many firms delay initial merger considerations (setting criteria and identifying potential partners) until they *"get their house in order."* For many firms, this becomes the Man of La Mancha's *"impossible dream."* It is better to recognize that making hard decisions and doing what those decisions call for is more of a journey than a destination. In effect, *"getting your house in order"* is really a phrase to describe the concept of continuous improvement – something a firm will always be doing. In a competitive environment, all law firms have to continue to improve, not unlike companies in all industries. So, demonstrating that you are addressing *"what needs to be done"* is sufficient for merger considerations – because you can bet the other firm also has identified a list of things to do to *"get their house in order."*

- While it is important to consider the merging of firmwide functions (governance and voting, partner compensation, etc.), we suggest that both firms really focus on the *"client facing"* functions of new firm (practice and industry teams, marketing, client communications, etc.). The sooner you can put together a client service delivery structure and gain internal acceptance on it, the closer you are to success. We believe, except in unusual circumstances, that there should be only one practice/industry team leader for each practice/industry team. Yes compromises will have to be made, but that is the nature of a merger.

- We have saved effective integration for last, but it is critically important and very, very critical to the combined firm's future (it is critical to creating a *"family"*). It is a topic not discussed as much as others, but those firms who have completed successful mergers have clearly underscored the importance of integration (or, the successful execution of the merger). Successful integration requires leadership (someone has to be in charge); planning (who will do what and when); reacting to the unexpected (such as a key partner leaving – one you do not want to lose), accountability (best answered by rewards and sanctions); and, critically communications, communications, and even more communications. Our suggestions are simple – research what others have done (and learned), develop a detailed integration/execution plan (tasks, timing, responsibility, and costs), assign responsibility (to a number of people – not just the Managing Partner) for carrying it out, and adjust that plan often during the execution.

While we could provide a long list of *"to dos"* that may or may not fit the unique needs of the readers of this monograph, we thought it important to relay the advice of our partner, Joe Walker, who effectively completed ten successful mergers while Managing Partner of Plunkett Cooney. Joe had two *"gut feel"* rules that we really like.

- First, he and his partners evaluating a merger always asked the simple question, *"do we like these gals and guys or not?"* If a yes, they went forward – if no, they did not. Gut feel is very important in this process.

- Second, if the leader on the other side was a jerk with an ego (actually, every jerk has an ego, regardless of how unjustified it may be), they would walk away, as in *"there is zero chance for success."*

About Smock Law Firm Consultants

Smock Law Firm Consultants is a focused strategic management consulting firm serving law firms (our primary industry concentration and over 80% of our work), other professional service firms, and commercial entities. We help law firms address and resolve those key issues that have a major impact on a firm's near term success and its long term direction and focus. We have seven key areas of practice – (1) **strategic planning** at firm and practice levels; (2) **strategic plan implementation and execution**, in essence, helping our clients do what they said they would do; (3) **mergers and combinations assistance**, helping identify, negotiate and implement combinations; (4) **practice team/group management**, helping the practice team concept achieve its potential; (5) **law firm economics**, helping our clients improve profitability and deal with longer term financial issues; (6) **operational excellence**, improving both the effectiveness and efficiency of firm operations (i.e. – process improvement); and (7) **strategic management issue resolution**, assisting in resolving issues of vexing management concern.

SLFC has conducted a wide range of law firm merger/combination assignments over the years involving all four phases we discussed earlier in this monograph – *dating, courtship, wedding/marriage, and family*. We have served individual firms, represented the combined firm, conducted one-off *"go/no go"* assignments, and developed criteria – dictated merger partner *"short lists."* We also pioneered the *"no success fee"* concept – an approach we feel preserves objectivity and best serves our clients.

We believe there are three key factors that clearly set SLFC apart.

- The primary success factor for any consulting firm is the results achieved by our clients – in both the near and longer term. Our client references speak directly to the results achieved.

- Our first string and, actually, our only string (Smock, Giuliani, Fiebert, and Walker) is, simply, the most experienced group on senior consultants serving the legal profession. The four partners bring a collective relevant experience of greater than 160 years and each has greater than 40 years of varying but relevant experience in law and professional service firm management.

- We tailor our approach to every consulting assignment to the unique needs and requirements of the client. We are known for our originality and creativity in doing that and for our scrupulous avoidance of law firm management dogma.

*   *   *   *   *

John S. Smock / jsmock@smocklawfirmconsultants.com / 847.457.6121

Peter A. Giuliani / pgiuliani@smocklawfirmconsultants.com / 847.457.6123

Gary B. Fiebert / gfiebert@smocklawfirmconsultants.com /847.457.6122

Joseph V. Walker / jwalker@smocklawfirmconsultants.com / 847.457.6125