

How to Tell if Partners Are Ready to Merge

Recently, it seems that most publications focusing on the state of the legal industry include a line or two on firms that are looking for merger partners, that are involved in merger negotiations or whose partners have voted to merge. For many firms, the desire to merge stems from one of two forces operating outside the legal market.

First, non-legal industries are consolidating rapidly on a global scale. For law firms, this consolidation may eliminate one or more long-term client relationships. In some cases, a client's new or surviving management may choose other outside counsel, ending the firm's relationship. [Many law firms are looking to merge with others in an attempt to create organizations that are better positioned to hold on to the work of key clients](#), no matter what changes individual clients may experience.

Second, large accounting firms and other service providers are positioning themselves to offer a broader array of "legal" services to the clients of traditional law firms. The sheer number of lawyers now employed by accounting firms and recent decisions by some law firms overseas to join forces with accounting firms only amplify this threat.

For many law firms, the best way to manage the severity of these potential threats--and at the same time pick up needed expertise--is to grow through merger. In effect, the partners of these firms believe that the only way to fight size is with size. These partners believe that a larger, more diverse organization will be better positioned to service all of a client's needs.

While reacting to external market forces makes sense, every firm considering merger needs to assess whether it is truly ready to merge. Too often, a firm looks for a merger partner or gets involved in merger discussions with another firm before resolving its own internal issues. While such a firm may succeed ultimately in merging, the internal "baggage" it carries into a merger puts it at a definite disadvantage vis-a-vis its merger partner.

All firms, regardless of size, need to be aware of the issues that affect their desirability to others. Here are some key areas that every firm should be well aware of before beginning serious discussions with another firm:

Culture. It may be true that opposites attract; however, they may not make good partners. Given the importance and operational pervasiveness of firm culture, significant cultural differences between firms usually kill deals. In most cases, mergers succeed when both firms have common visions of management, strategic goals, productivity and work intake standards, compensation and professional and ethical beliefs. Before starting a merger search, understand (and be able to clearly explain to others) the firm's culture and values.

Perception. It is also a good idea to evaluate the public and community perception of the firm. Firms that are viewed negatively (whether fairly or not) may be unable to attract the quality candidates they seek. Potential merger candidates often back away from firms viewed as lacking direction or leadership or being inconsistent in work quality. In most cases, merger partners are not looking to solve another firm's problems. For a firm that is viewed negatively, a sustained effort to improve public perception may be necessary to enhance its desirability and expand the range of potential merger partners.

Branch Offices. Most firms search for merger partners with the idea of combining two complete organizations. For those firms with "renegade" branch offices, this can be a difficult feat. Merger partners often balk at merging with a firm that has a disruptive branch office. For firms with such offices, the

alternatives include bringing the branch back into the fold or deciding whether the deal can be completed without that office. Firms considering merger need to evaluate these alternatives with the understanding that problematic branch offices can severely limit **merger opportunities**.

Synergy. In any merger, firms need to focus on the real potential for growth that might come out of the transaction. That is, by merging, the new firm should reach a market position that neither firm could achieve on its own. Firms that are able to realistically assess their practice strengths and weaknesses are better positioned to identify more suitable potential merger partners and articulate the synergies possible in the combined firm.

Client Relationships. Merger partners may be concerned about firms that have failed to institutionalize their clients or are overly reliant on a small group of clients. The simple fear that a group of partners (and perhaps a significant source of revenue) could walk out the door at the first sign of post-merger trouble can be enough to squelch a deal. For firms where clients and revenue are concentrated in the hands of a few partners, merger synergy, strong personal relationships and a shared vision of the merged firm may help minimize post-merger fallout. For these firms, it is crucial that the key revenue generators see and commit themselves to the potential value of the merged firm.

Unfunded Retirement Plans. Due in part to the well-publicized problems with unfunded retirement plans, many firms have made significant strides toward curtailing or eliminating their obligations. For those that have not, the potential liability can be staggering and the merger prospects close to zero. Before undertaking a merger search, quantify or, better yet, eliminate any unfunded obligations. Failing to do so puts a firm in a weaker bargaining position. This is particularly true if the other firm dealt with its retirement liability issues before coming to the discussion. In most cases, partners of the firm without the liability will resist making any payments of "their earnings" to the other firm's retired partners.

Capital. Major differences in capitalization philosophy or per-partner capital levels (cash or accrual) can doom a potential merger. In firms organized as corporations, there is a tax incentive for shareholders to minimize taxable net income; as a result, these firms may be under-capitalized. In a merger, the combination of firms with disparate capital positions may require one group of partners to contribute capital to the new firm. Before starting a merger search, the willingness of the firm's partners to contribute additional capital to the new firm, if needed, must be evaluated. If there is significant reluctance, merger opportunities may be limited.

Finances. Financial history and work ethic play leading roles throughout merger negotiations. Usually, it helps to review at least three years of historical financial performance in the early stages of discussions. Firms with a history of below-average performance negotiate from a position of weakness and are susceptible to cherry-picking. A merger may be beyond the reach of such firms unless and until the firm's economics improve. Even if firm cultures mesh effectively, synergies are apparent, and client conflicts are minimal, major differences in economic performance may not be easy to overcome. On the other hand, firms that consistently outperform their market tend to have the upper hand in a merger search, provided they are willing to look at firms with a broad range of economic performance levels.

Debt. Many firms have debt as a result of a computer enhancement or office build-out. Some have debt, but no offsetting asset. The major issue is to determine where the money went. Most firms will avoid a merger partner that used debt to compensate partners rather than enhance the firm's operations. Firms with "partner compensation" debt and a desire to merge must eliminate that debt as quickly as possible and create and enforce policies that ensure that any line-of-credit borrowing is limited to asset-related matters only. Finally, every firm must be aware of any debt covenants that may impair its ability to combine with another (e.g., personal liability issues, partner capitalization requirements, limitations on new offices).

Leases. Despite the importance of financial history, merger partners are usually more interested in post-merger finances. A big jump in occupancy costs could be hard to swallow. Two lease-expiration issues are primary. First is the effect of a lease expiration in a more expensive market than when the lease was negotiated. For a 50-lawyer (25-partner) firm in the last stages of a lease for 50,000 square feet at \$25 per foot, a jump in the rental rate to \$32 effectively decreases each partner's net income by \$14,000, all things being equal. Second, depending on lease terms, partners may be personally liable for the rent. This is often a deal-breaker. These problems have no simple remedies but demand time, creativity and hard work.

This list should provide a reality check for firms considering merger. Clearly, the primary issues in [law firm mergers vary from firm to firm and deal to deal](#). However, having a clear sense of how the firm stands on each of these key issues will enhance its merger prospects, help achieve a viable combination and minimize the time that can be wasted in unproductive discussions.

Interested in Learning More About Legal Hiring? Read the Definitive Guide:

[How to Hire a Legal Recruiter for Your Law Firm: How Law Firms Recruit Attorneys Using Legal Recruiters](#)