Typical Obstacles to Mergers

As the economy changes pace, more firms than ever are shifting their focus from acquiring new associates to procuring partners and the client relationships that accompany it. As a result, the interest in law firm mergers is higher than ever, and there are a growing number of merger discussions occurring in California.

But with the increasing interest in law firm mergers comes an increase in ill-conceived and poorly structured mergers. Too often, firms enter into merger discussions for the wrong reasons, fail to carry out a thoughtful, disciplined analysis of the prospective deal or make fundamental mistakes in structuring the new combination of firms. As a result, while some firms are merging with success, many others are finding that their mergers are failures.

A common issue arising when firm leaders negotiate a merger for the first time on their own is that they assume law firm mergers work like most client mergers.

Many a corporate lawyer has commented, "I do mergers every day of my life, and I can negotiate this deal in my sleep."

The reality, however, is that law firm mergers tend to have far fewer financial issues and far more complex people and structural issues than other corporate mergers. Unlike most client companies where the machinery doesn't have the option of getting up and walking away if the new corporation's new strategy, structure or leadership doesn't work, the operating assets in a law firm are people who can leave if they don't like the new arrangement.

Another problem encountered is the failure to adequately examine the business case for the merger. These mergers often are predicated on friendships or unrealistic assumptions about the prospective benefits.

Because of these and a myriad of other problems that a merger can encounter, a few fundamental questions should be asked of every prospective merger. Many firms that attempt to merge come across similar, sometimes insurmountable issues. Recognizing typical merger obstacles is the first step toward overcoming them and achieving long-term success.

What can the firms accomplish together that cannot be realized separately?
Even if there is a theoretical business model arising out of a merger, firms need to address the tougher issue: Can they actually make it work? If the firm hasn't accomplished similar business objectives in the past, are the previous roadblocks eliminated simply through the structural combination of two firms? Also, do the firms have the culture and infrastructure to share work, clients and resources, or will the firms simply end up creating a bigger entity that never takes advantage of the strengths created?

Do the firms share a common philosophy about compensation and other work place issues?
Many mergers have been put together using a common structural tool that allows each predecessor firm to set its own compensation for the first one or two years. While this mechanism can be useful in integrating cultures, too many leaders use it to avoid the more difficult question of whether there is a shared philosophy about compensation or economics.

No compensation system will overcome fundamental differences in monetary or other workplace philosophy. Some firms are more driven by seniority, while others value production or merit. Other firms differ regarding work ethic and expect different work levels and hours from their staff and lawyers.

Or firm economics could vary. For instance, law firm mergers become increasingly difficult, if not impossible, when the differential in net profits per partner exceeds 20 percent.

Substantial differences in these considerations could spell doom for a prospective merger.

Have the firms checked potential conflicts of interest early and often?
The single greatest reason that most law firm mergers fall apart is conflicts of interest, both true legal conflicts or perceived business conflicts. Yet when entering their first merger discussions, most firms fail to address this topic early or often enough in their negotiations.

Once it has been decided that the possible merger has merit and a methodical plan is laid out for considering and negotiating merger issues, a comprehensive process for checking conflicts should be undertaken immediately. The leadership teams should address large-scale conflicts, check the basic posture of each firm's practices and client base and evaluate whether there is a conflict in client or market strategy.

One individual from each firm then should be appointed to serve as conflicts liaison throughout the negotiation period to implement a methodical program of conflicts checking. And for this process to work, both sides must provide a detailed list of clients and cross parties, and each side must perform its own conflicts check, as history has shown that one-sided checks frequently overlook conflicts.

When practice leaders and groups from each firm meet, conflict issues should be a primary agenda item. This is one of the best means for discovering conflicts that may not rise to the level of true legal conflicts, but which might cause client apprehension or losses if the merger were to proceed.

Last, and most important, establish a system that will ensure that all new clients get checked throughout the negotiation period. Many significant mergers have been called off at the last minute because one side failed to notify the other of a new client taken on after the initial conflicts check was performed.

How should firms identify and approach potential merger targets?
For many firms, the search for a merger candidate is handled more like a junior high school crush than a prospective wedding. Too often, the wrong partners are contacted, the message is little more than a vague inquiry and few meaningful discussions take place. Instead, consider these rules.

First, make sure you know a lot about a firm before you approach firm leaders. Due diligence does not mean gathering loose observations from a few partners or hearing third-hand stories that may not correctly reflect the firm's current structure or market position.

Second, start at the top. Initiate talks with the managing partner, chair or other member of the leadership committee.

Third, be prepared to discuss your own firm's strategy and why you are interested in a merger. Only this level of discussion will generate any significant interest. Too often, firms ask their partners or headhunters to engage in merger inquiries without the benefit of deep, well-structured information.

Many ultimately useless merger inquiries are completed in less than 30 minutes largely because the inquiring party can't provide a meaningful answer to the question, "Why are you interested in doing this and what benefit would there be to the combination of the firms?"

Have the firms reconciled any unfunded retirement, compensation or buyout arrangements?
While the number of firms with unfunded obligations to retiring, withdrawn or deceased partners has declined dramatically over the last 10 years, many firms still have these legacy programs in place. Any firm that diverts more than 3 percent of current income to retired, withdrawn or deceased partners probably will be at a

disadvantage in a possible merger. The merger partner will not want to assume an obligation for which it receives no benefit, and most firms that have failed to address such problems are ill-equipped to rectify such issues in the midst of merger negotiations.

Have name issues been discussed early?
Another common reason for merger negotiations to fail is disputes over the name of the newly merged firm. While it may seem like a silly issue, experienced merger negotiators will discuss the name issue first to avoid wasting time in negotiations.

Are the firms working on big issues first and reserving smaller issues for later?
A common problem that plagues many merger discussions is the failure to impose a rigorous structure to merger discussions. As a result, participants end up trading too many war stories at the outset of the discussions and fail to resolve the important issues. Many merger discussions have unnecessarily gone on for months because they are plagued with fundamental cultural structural or strategy issues that will prevent the firms from ever consummating a successful merger.