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MERGERS HAVE INCREASED SUBSTANTIALLY THIS YEAR, BUT PAY ATTENTION TO THE RED FLAGS

by

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MERGERS HAVE INCREASED SUBSTANTIALLY THIS YEAR BUT PAY ATTENTION TO THE RED FLAGS

There have already been a record number of mergers completed or announced this year. The principal reason, of course, is the picture in the legal profession. For many of the top 200 firms mergers, which in most cases are really acquisitions, are the major piece of their growth strategy in a flat or shrinking market. For other firms, merger is the alternative to dissolution.

However, a look at history reveals that about 50% of all mergers subsequently fail. In many cases the reason(s) for these failures were issues that were evident beforehand and should have been recognized and addressed by one or both of the firms involved. We describe these as “red flag issues” because they should either be resolved before the merger is finalized or indicate that the firms should not merge. 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 for whom we performed merger due diligence: One firm was highly profitable and its practice consisted mainly of major, “bet the company” cases for large corporations. The other firm was marginally profitable and its practice was largely commodity litigation with a high percentage of insurance work at far lower hourly rates. Note: They wisely decided not to merge.
- 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.
- The major rainmaker 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. Another example: One firm has a formulaic system while the other firm has a subjective system.

- "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 merged 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 be retained. 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 early in the process 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 one 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 resource spent on potential mergers that never occur if firms recognized and address the red flags.

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

For *a comprehensive discussion of the merger process, visit our web site www.roberetdenney.com, and click on the article," A Primer on Law Firm Mergers".*

Robert Denney Associates Inc. has provided management. strategy and leadership counsel to law firms, companies and non-profit organizations throughout the United States and parts of Canada for over 30 years. Bob also serves as an outside Director on company boards and has served as an interim CEO in turnaround and crisis situations

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