

The merging risk

Nick Jarrett-Kerr examines mergers and risk in the current climate.

For at least the past two decades, pundits have been predicting law firm consolidation on a large scale, and have been anticipating frequent mergers in all tiers of the profession. Despite these predictions, the expected wave of merger activity has not yet happened, with the number of mergers at a low and static level for the past two years. It is not hard to find a reason. Lawyers and law firms are instinctively suspicious and wary of change. Firms tend to undertake deep and painful analysis of most projects and are risk averse to anything that might threaten the status quo.

In my experience of visiting scores of firms, cultural incompatibilities and perceived loss of independence are two of the most frequently cited reasons for abandoning merger discussions. Firms also tell me that they would like to improve their profitability so as to be in a stronger negotiating position, or that they would only consider merger with a firm rather smaller than themselves. In many cases, I don't buy the cultural incompatibility argument. I see many firms that are culturally and behaviourally fairly similar to each other and few that stand out as having a particularly unique set of values. In any event, most firms need to work hard on improving behaviours and cultural traits, and a post-merger integration programme is often well-suited to benefit all parties.

It is, however, not surprising that law firm mergers take place less frequently than many other areas of professional services, as lawyers cling to the sides of their existing vessels, however close they may be to being wrecked. The last of the great cottage industries is finding it hard to come to terms with the forces of consolidation.

The strategic drivers for merger or acquisition

It has frequently been observed that merger is not a strategy in itself, but needs to be considered as a tool to implement or assist strategy. Growth for growth's sake is not a strategy.

There are, however, some compelling reasons for attaining fast growth in size and substance through mergers and acquisitions. Every firm needs to consider the minimum amount of growth necessary for the firm, both to retain its existing market position and to maintain its strength and ability to perform or survive.

Clearly, all firms need to have a viable market standing. In a consolidating market, most firms, need a high minimum growth rate in order merely to stand still or maintain existing competitive advantage and levels of profitability. Certainly,

most firms that are seeking to compete in commercial areas of work need a minimum size in each of the main heavy lifting departments in order just to maintain its competitive edge, let alone improve it. The issues of scale, shape and growth are, therefore, increasingly affecting the potential of all law firms to compete. Mergers and acquisitions need to be considered against the background of the optimal size and shape of any law firm to maintain and improve its ability to compete.

There are seven essential ingredients for both the reduction of risk and a successful merger. These focus on a long-term vision, profitability growth and value enhancement for the firm's stakeholders. First, and most important, there must be a strong and logical strategic case for the deal as a tool to aid the firm's positioning and competitive strategy. Table one gives a checklist of strategic issues to be considered.

Second, the choice of target or merger partner has to be made carefully and methodically against the background of the agreed strategy. Many mergers fail because of a poor strategic or practice fit between the parties. It is helpful to prepare a list of the criteria and desirable attributes that the firm wants in its merger partner, in terms of the key strategic areas of positioning, size, geography, resources, specialisms and clients.

Third, the merger rationale must be logical and compelling, and free from personal considerations, greed or the lure of an exciting project. Subjective special pleading can take place at both ends of a personal risk/reward spectrum.

At one end, mergers are rejected by a coalition of leading players within one or other firm because of the threat to job security or personal comfort zones, or because of perceived loss of personal power.

At the other extreme, there may be partners who are seduced by the personal motivation and desire to maximise their own fortunes. Equally, law firm leaders can become tempted to engage in merger and acquisition projects of questionable value that promote their personal glory or position. There must be an honest appraisal of the total business case for the merger. It is not, for instance, sufficient to base a merger on the desirability of acquiring a particular individual or niche if all the other factors are negative.

Fourth, the firms must compile detailed and accurate inventories of each other's firms to ensure compatibility of client bases, accounting methodologies, cultures, systems and technical knowledge. Resources and capabilities must be identified and stress-tested for strategic importance and relative strength.

1.	Improvement of competitive positioning.
2.	Development of client service – quality/depth of specialisms; range of services; and, service delivery.
3.	Improving quality and substance – better knowledge management; better management of risk; and, better processes and systems.
4.	Extension of market place.
5.	Increasing leveraging and improving the client base.
6.	Improving the firm's resources.
7.	Developing and enhancing human capital – filling skills gaps; improving recruitment/retention potential; and, opportunities for further specialisation.
8.	Developing value creation – improving long term profitability; economies of scale and scope; more efficient lawyer deployment and utilisation; and, better rates.
9.	Positive effect on culture and behaviours – clarity of roles and expectations; improving discipline and accountability; and, building entrepreneurship and dynamism.
10.	Prioritisation of and plans to address structural, cultural and organisational impediments.

Table one – checklist for merger strategic planning

Fifth, early financial analysis is vital to ensure that a logical merger case survives harsh economic scrutiny. Firms will differ not only in their profitability, but also in their profit drivers, their leverage profile or the economics of different offices and different practice areas. Early financial analysis can sometimes highlight fundamental cultural differences in the approach to debt, partners' capital and long-term investment.

The firm's approach and attitude to work-in-progress and debtors can show discipline and accountability in one firm or a cavalier attitude of poor controls and laziness in another.

Clearly, issues of profitability are also vital. While it is possible to merge with significant differences in profits-per-equity-partner, the existence of a large differential may reflect poor management, different business recipes, difference in quality of client bases or regional variations, all of which need careful handling. Having said that, mergers do also give opportunities for economies of scale and scope, careful analysis and advocacy of which can be significant contributors to the success of merger discussions

Sixth is the achievement of robust and sensible management and governance. While structure always follows strategy, it is vital that the new firm is structurally organised to align with the firm's strategy for success. Most firms are far from being optimally managed; some are very badly run.

In the new world of the Legal Services Act 2007, the gap between well and badly run firms is sure to increase. One of the key challenges for the leadership of a newly merged firm is to decide who should be on board the new firm and who (put

bluntly) needs to be moved out. The tone set by the leaders in confronting performance (and underperformance) issues will define the new firm's path. The rising tide engendered by the merger-induced growth of the firm will not, in this case, lift all boats. The twin issues of over-partnered firms and underperforming partners will always need careful handling, as it will often be politically difficult to hold a partner cull in the early months of the new firm. And yet there is a great deal to be said for confronting such a disagreeable task at an early stage. To deal with this, an early task is to agree and introduce a comprehensive performance management and partner development programme.

The seventh ingredient is the realistic but urgent development and implementation of post-merger integration plans. This is easier said than done. Most lawyers are used to definable transactions and assignments in their working lives at the 'hard' end of the project spectrum. It's the 'soft' projects (those involving people, teamwork, behaviours, values and culture) that have time and again proved to be so much harder to implement. Such projects are important at all times, but particularly when new people are around. And what's more, these projects need sustained and committed leadership from the top and much more than lip service from the partners at all levels.

It is, therefore, important to work out an integration programme or project that is long-lasting and sustained, and that reaches team and individual level. Care must be taken to manage expectations from the very start, recognising that there can be casualties and planning for that eventuality. Partners and staff should be encouraged to spend as much time as possible getting to know each other both formally and informally. Further, leaders should form action plans to work out particular areas of cultural difference that need development.

Overstating the risk

Merging is always attended by risk, and we can all point to examples of hasty or ill-considered unions that have ended in tears. For many firms, the risk of doing nothing exceeds the risk of decisive, bold and brave action.

If the strategic and financial considerations of a well-researched merger opportunity can all be made to stack up, there is a lot to be said for ignoring the reservations of a cautious (albeit vocal) minority and forging ahead. Provided that the seven ingredients listed are systematically taken into account and applied, mergers can be part of the recipe for a successful future in a consolidating market. *FDLegal*



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