Keeping Your Options Open: Preparing for Strategic Flexibility in a Competitive Legal Environment

By Joseph B. Altonji on January 24, 2023

While the post-pandemic merger pace is slower than many expected, law firm combinations are clearly on the rise. More significantly, recent announcements suggest that the number of larger combinations are also on the rise, with more in the works. Clearly, many firms are beginning to (re)consider their futures as we've moved from the crisis of the pandemic, through a period of major demand for talent and salary wars, to a current position featuring much more challenging economic times and heightened uncertainty. Combined with general environmental changes over the past decade which have clearly increased the benefits of scale, most firms should at least periodically review their strategies and goals and evaluate the platform choices that are most likely to put the firm, its clients, and its people in the best position possible to succeed and thrive.

This does not necessarily mean the firm should merge! There are many firms whose practices are better off as part of a smaller, independent firm, and this will likely remain true for the long term. We are *not* suggesting that every firm must merge to remain successful. However, over the years we have seen many firms who long resisted the idea of combining with any other firm suddenly change their mind following some unanticipated event or circumstance. Many of these then struggled to achieve a "successful" combination because of conditions at their firm, forcing very difficult choices in the process. The firms best positioned to do a smooth and "painless" combination are often the ones who least need to do it – the ones who are healthy, thriving, and have few if any material impairments to their business success. Put differently, the things you need to do to put yourself in an ideal position as a combination candidate are very similar, if not identical, to the things you need to do to assure your optimal success as an independent law firm.

Based on significant recent experiences, we offer a short list of five initiatives your firm can undertake to both a create a path forward for a successful future as an independent firm, as well as position you well, should you decide to combine (for the right reasons) with someone else:

1. *Shore up your balance sheet:* Many firms (particularly small to midsize firms) have long resisted the need for adequate capital, preferring to live with a combination of debt, deferred maintenance, and hand-to-mouth funding while offering limited monthly draws and hoping for strong collections at year end to pay off their lines and fund distributions. These firms are at serious risk of losing their best people during off years (especially) and may be poorly positioned to attract good talent when the opportunity arises. We have also been involved in multiple recent combination discussions where the strategic value of the combination, and cultural fits were excellent, but the balance sheet challenges threatened to kill the discussions, and very difficult choices and/or concessions had to be made to move forward. Building a strong, clean balance sheet is a critical effort no matter what direction you wish to go. (Note that we use the term "balance sheet" in a broad economic sense, not just a strict accounting sense.   Unfunded liabilities, underfunded pension plans, excessive lease commitments, contingent liabilities, deferred retirement contributions, excessive uncollectible inventory and other components are all elements of a firm's balance sheet health, even if they are not reflected in a firm's typically cash-basis financial statements.)
2. *Deal with your a—hole (and other problem partner) issues:* Many firms claim to have a "no a—hole rule" but in practice really don't. Enough economic clout seems to cloud the judgement of many leaders (or they are just unwilling to confront bullies). However, despite the revenue some of these people bring, they are invariably more of

a drag on the firm than an advantage. It's very hard to grow the firm when potential recruits see jerks being coddled, and any quality firm you might want to connect with is unlikely to want to adopt your problem children. In law firms, as in other businesses, high quality cultures are associated with better economic performance, and addressing the people who detract from the firm's culture will better position the firm for any type of future.

3. *Clarify your strategy and align your practices*: Many smaller firms were built up around the practices of the founding partners, who often came together based more on friendship and relationships than strategic logic. Fast forward a couple of decades, and these firms are frequently a mixed bag of practitioners who "do their own thing" from a practice perspective, assuming no direct ethical conflicts. They may appear to be happy but there is limited cross selling in the practice, and economic performance growth tends to be modest. As it relates to strategic options, we often see this lack of discipline result in material conflicts – either actual ethical challenges or business conflicts – that make the firm an impossible whole firm combination candidate. A strategic *choice* to remain independent is one thing. Being forced to remain independent because of undisciplined practice growth is another.
4. *Invest in infrastructure and technology:* Weaker firms, often with an aging partner contingent, will sometimes defer investment in technology, administrative support personnel (including key new position needs), training, efficient and modern space, and other critical needs to support income, especially during down periods. While this might boost short term profits, the inevitable result will be the firm falls behind on all operational fronts over a slightly longer period. Performance lags, recruiting lags and the firm has more difficulty hiring good people. When things get bad enough, the firm decides it "needs to merge" but finds that few good firms want to take on the mess. Instead, potential merger partners are more likely to be interested in a handful of good people the firm still has, resulting in an even more challenging future.
5. *Move away from heavily formulaic and "eat-what-you-kill" compensation approaches:* While almost all law firms use economic contribution as a significant component of their compensation setting, few large (or not so large), successful firms are strictly formulaic. Most successful firms of all sizes rely on a degree of discretion to reward behaviors that are not strictly measurable in dollars. Conversely, firms that rely on strict formulas (especially smaller firms) find that they get limited contributions beyond what is rewarded by the formula. Sharing, practice management, training and many other critical values get shortchanged. Paradoxically, the partners living in formulaic environments really like these systems – they provide significant certainty and help them get over their general lack of trust in others making decisions. But more often than not, they hold the firm back, and they would almost never survive in a merger (although partners' fear of moving away from a formula might result in a great merger opportunity being voted down.) Move away from heavily formulaic approaches toward ones where economic contributions are measured and counted, but where there are strong incentives to contribute beyond the headline economics. Your firm will be better off whatever direction it heads.

There are many other things any firm can do to better position itself, both as an independent firm and as a merger candidate. However, the list above offers a short set of challenges that could be addressed as part of your 2023 management agenda. Hopefully your firm does not have all five of these issues, but even if you do, we urge you to set an agenda that, within a reasonable period, will materially change your position on each of them. We are confident that if you address each of these you will find your firm moving toward a much stronger independent position (including higher profitability) *and* you will be far better positioned as a merger partner should you ever decide to go that route. Either way, you keep your options open – and improving.