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Law Firm Mergers in the Time of (and After) COVID

By Joseph B. Altonji on December 8, 2020

Since the COVID epidemic took hold there has been a significant reduction in the number of law firm mergers and acquisition transactions announced, and an even greater drop off in larger transactions. Few deals announced since March included an acquired firm of 10 lawyers or more, with only Dentons' combination with 96-lawyer Durham Jones & Pinegar, involving a smaller partner with more than 50. Just as significantly, there have been no transactions announced since COVID that could be described as "Mergers of Equals." The reasons for the drop offs are obvious – first, the tremendous distraction created by the early days of COVID where everyone's attention was focused on functionality, followed by the continued uncertainty around the future and this year's economic outcomes. These issues combined with the extreme difficulty of managing important aspects of transactions, especially the critically important "getting to know" your potential new partners and building confidence in a cultural fit have made getting deals done hard. Nevertheless, most commentators on the profession predict a significant upturn in merger and combination activity going forward, and our own clients are increasingly interested in pursuing combinations.

We will soon put 2020 behind us, knowing that the early fears around the economic impact of COVID will be largely unrealized, with some firms actually seeing their best economic years ever. There will be tremendous pressures on leaders to put 2020 behind them and get back on their strategic game plans. We believe there will also be significant efforts to rethink strategic positioning followed by much greater receptivity to the idea of benefits from scale and platform strength. As a result, there will be more interest among acquisition targets in combining with larger firms – or at least with other firms of similar size.   But how will transactions get done?

At least for the next several months, travel will remain difficult as will the normal social interaction components of partnerships getting to know each other, which is so important in building confidence in potential combinations. Will firms continue to postpone conversations until conditions allow in-person meetings and social gatherings and let merger negotiations get "back to normal"? (Likely setting back valuable deals many more months and potentially losing some opportunities.) Or will law firm leaders use this opportunity to rethink how they approach merger discussions, potentially creating materially improved evaluation practices and increasing the probabilities that the ultimate transactions will be successful longer term? While in-person meetings and social events will always have value, we believe that more investments of time in rigorous deal analytics across a range of subjects will have more value, in terms of ferreting out deals that are likely to disappoint, than additional time spent having partners get together to drive "comfort."

In September, my partner Mike Short presented an analysis of "Why So Many Law Firm Merger Attempts Fail." Some of the same reasons Mike identified as killing deals – especially cultural or economic mismatches, but also lack of a true strategic business case – also lead to actual mergers that disappoint both firms, and often to the gradual disappearance of many valuable partners from the acquired firm.   How can this happen if so much of the pre-deal negotiation time and effort is focused on these topics?   Part of the answer is that, often, much of this work is superficial and other components of it are based on gut feelings (often of a limited number of powerful people) rather than on hard analytic efforts to understand the respective firms. It is surprising to us how many firms are willing to pay millions for "finders fees" to identify firms ultimately willing to do a deal but will cut corners on the investment (whether with internal resources or external help) needed to evaluate a deal in depth. It is possible that the current challenges with in-person meetings could inspire more firms to lean more heavily on deep analytics and real data to evaluate fit, and that better merger analysis practices may carry forward past the pandemic, even once we add back more in-person time. Consider a few key areas of merger evaluation:

Culture

In most merger negotiations, “cultural fit” is primarily assessed based on the gut feelings of the respective firms’ partners who actually meet each other during the negotiations, supplemented to a degree with discussions about whether the firms have “comparable work ethics” or maybe “similar views on compensation and capital, or transparency” or maybe similar commitments to diversity and inclusion.   However, the larger the respective parties to a combination actually are, the smaller the percentage of partners who really get to know each other and the more likely these evaluations will disproportionately rely on the respective impressions of the leadership teams. Even if these conversations are widespread and well-meaning, unless there are some particularly egregious and obvious issues, they will rarely get to level of understanding needed to assess whether one firm operates with, for example, a passive or defensive style of culture while the other is far more constructive. Nor will it likely tell you that while much of the proposed transaction will be very positive, the respective litigation groups might melt down if you try to combine them due to serious differences in leadership styles.

We recommend that in important merger discussions, and certainly in any Merger-of-Equals situation, that the firms invest in the serious scientific analytic efforts that can ferret out important differences in culture, and supplement those with the normal in-person (once we can do that again) gut feelings and other inputs. In a worst-case scenario, both firms will gain a much better understanding of their own cultures and issues. If the deal goes forward, it will both provide the respective partnerships with greater confidence in the cultural compatibility of the firms, as well as provide leadership of the combined firm with significant insights into what will be needed (at a granular level, including on a practice and office level basis) to realize the greatest success from the deal.

Financial Analytics

A great deal of financial analysis goes into most merger conversations, but there is room for additional refinement in most cases. In general, these analytics are focused on comparisons of the past and equalizing statistics, rather than focusing on opportunities for the future and building profitably for the future.   Merger teams will look deeply at indicators such as profit/partner, revenue per lawyer and billable hours, but focus much less intently on how bringing the firms together can create opportunities for improving profitability and driving new revenues (this might be *discussed* in talks but is far less likely to be modeled or assessed analytically.) Going further, there are always opportunities to develop a better understanding of exactly what the economic challenges of integrating the firms will be.   Can the smaller firm raise its rates to better fit into the rate structure of the larger firm? If yes, the analysis stops. If no, maybe we go a bit deeper and try to figure out a work around. What if two litigation practices are producing the same economic contributions, but in very different ways? Or what if both firms have similar realization rates that are generated through very different sets of business practices?

There is certainly room for a significantly better understanding of the economic challenges and opportunities implicit in any potential merger transaction, and we encourage firms to focus on much more intensive analytical approaches before truly getting excited about the proposed combination.

Compensation Philosophy

The firms have similar profits per partner, and utilize an open, subjective, points-based compensation system managed by the Executive Committee. Everything’s fine, right? Well maybe, but maybe not.   Just because these headline topics line up does not mean that the firms actually share a similar compensation philosophy, or that similarly situated and contributing partners would be treated the same at both firms. Likewise, just because these topics do not line up does not mean the systems are incompatible. Understanding what is important to each firm – which the firms do not always fully understand themselves — and how each firm operates its compensation system is crucial to assuring the firms are well matched, and this evaluation can be significantly advanced with an appropriate investment in analytics and detailed discussion. This is often critical in making compensation integration (and therefore the deal) successful or will occasionally result in identifying unbridgeable gaps between the firms. In addition, these analytics can be an important data-driven component of the cultural discussion outlined above.

Strategic Value

Why both firms are trying to do the deal is often a poorly developed concept. While the smaller firm's rationale may be as simple as wanting to ensure the continued viability of the firm, the larger firm's rationale could often benefit from some serious additional thought. "We're a national firm, so it's logical for us to be in Houston" is hardly a reason for approaching a particular law firm. Many deals are non-starters because an arrogant firm comes to town and approaches every smaller firm in the city, basically saying "you should join us because we're really good" without having given any consideration to what might really be in it for the reticent and skeptical smaller target. We urge all firms to develop much more considered strategic frameworks for what you are doing and have a tailored value proposition for every firm you approach.

COVID has slowed down announced combinations dramatically, but we have already experienced an uptick in interest in conversations and we will soon go back to a more intense and competitive environment for law firm mergers. Firms wishing to come out on the winning side would benefit dramatically from using this period to rethink how they approach merger. Although there will always be a place for in-person meetings, Zoom and similar platforms will likely permanently displace many meetings. Use the resources saved to make better and more intense investments in the analytics needed to 1) make sure you get the deal right (or kill it if it is likely to be a long-term dud) and 2) position both your firms to far more quickly achieve the goals which drove the inquiry in the first place. As in so many areas of law firm management, COVID has created an opportunity to significantly improve our practices.