Law Firm mergers: Finding the Right Fit

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Law Firm Mergers: Finding the Right Fit

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When law firms merge, making sure one firm’s culture and people fit well with the other can be a daunting task, so a pre-merger assessment should be carried out to ensure the best chance of success. This article highlights the need for organisational fit assessment and provides suggestions how to improve the process.

Mergers and acquisitions are an important strategy to grow law firms, move into new geographic regions, add new services and gain skills. Law firm merger activity is high with large Australian firms such as Allens, Mallesons and Freehills announcing mergers with international firms in recent years, mid tier firms continuing to add offices and teams from other practices and publicly owned law firms, Slater and Gordon and Integrated Legal Holdings, acquiring many small to medium sized practices.

However, not all legal firm mergers go smoothly, especially if there are flaws in the merger process that were not adequately identified, or substantial cultural and other organisational differences between the firms were not addressed before the merger. Poor organisational fit between the merging firms can result in:

- **Distraction and conflict** over how the merged firm should operate,
- **Frustration** with adopting new processes and dealing with staff with different skill levels,
- **Poor morale** as professionals feel that their reputations and self images are tarnished by associating with a perceived inferior merger partner,
- ‘Us’ and ‘Them’ attitudes can remain for years post merger,
- **Resistance** to integration activities resulting in the failure to achieve planned merger benefits, and
- **Defection** of partners, staff and clients.

This article describes the concept of organisational fit, why it is important to examine fit before the merger/acquisition, some causes for failed assessment and provides some suggestions for assessing the fit of potential merger partners.

What is Organisational Fit?

Organisational fit is the degree of alignment of the way each of the merging firms operate compared to each other and compared to how it is planned for the merged firm to operate. The way of operating includes structure/ systems fit and people fit.

**Structure/ systems fit**

There are many factors to consider when considering a structural and systems fit that law firms intending to merge should consider.

- **Governance:** This is how the firm is managed. To what degree are decisions made democratically by the partners or made by a centralised management group or by a single autocratic managing partner? Partners from smaller firms may have substantial difficulty adjusting to the reduced line partner input on firm decisions on joining a large firm with a more corporate governance system.
- **Partner compensation:** This includes the levels of compensation and how compensation is determined. In some cases, senior partners of one of the merging firms may need to agree to compensation reductions to align the compensation grids. The method of determining compensation is insightful as it indicates the behaviour rewarded in each firm and can highlight potential significant cultural differences. For example, one firm may use the lockstep method rewarding seniority while the potential merging firm may reward individual performance. Moving to a new compensation system can involve substantial culture change and angst.
- **Exiting/ retiring partners:** The ability of firms to exit partners and mandatory retirement ages may differ across firms as will the benefits paid to exiting partners. For example one of the merging firms may pay pensions to retired partners out of current earnings while the other firm may not pay pensions at all.
- **Firm financing:** Some firms are financed through partner contributed capital whilst others are financed through bank debt. Merging firms with different funding models may require substantial capital investment by partners from one of the firms.
- **Commerciality/ sophistication of processes:** There can be a large range in the level of sophistication of processes and systems used in different firms resulting in conflict and requiring significant training post merger. For example some firms are less commercial than others utilising cash as opposed to accrual accounting in their practice and irregular billing and collection of receivables.
Organisational structure: Firms can be structured in many ways including: local office by service line, national service line and industry grouping. Moving to a new structure can cause significant distraction as it significantly reduces the power of partners in charge of business units under the old structure and impacts on the client relationships of professionals.

Roles of partners: There are a number of different activities that partners are expected to perform across different practices with significant variation across the proportions performed. For example, in one practice partners may spend the majority of their time in client relationship and selling activities with all technical work delegated to staff. In another practice, the partners may be more hands on, working on client files with high chargeability expected. This can result in conflict in the post merger firm, with partners from one firm considering the other firm partners are not charging enough time, and partners from the other firm believing that partners from the first firm are not operating at partner level.

Rates: Firms who focus on the middle market generally have lower hourly rates than those focussed on the top end of town. Attempts to harmonise rates can create frustration with rates no longer competitive to deal with existing smaller clients.

People fit
Two major factors of people fit are culture and skills.

While a firm’s culture is made up of many attributes, the following four substantial opposing cultural characteristics appear more likely to clash post merger.

Standardisation versus entrepreneurship. Standardisation represents the degree that services provided and processes utilised and documented across the firm are standardised and enforced. Entrepreneurship represents the degree to which professionals within the practice determine services to be provided and how these services will be delivered.

Individual versus team. Some practices are effectively groupings of sole practitioners looking after their clients while in other firms multiple practitioners work together to service clients.

Lifestyle versus profit generation. In some practices a balanced life is important with willingness to trade off potential profits for time with family and other pursuits. In other practices the emphasis is on working to maximise income.

Farmer versus hunter. While some firms are focussed on long term relationships and service for existing clients, others are more transactional, rewarding and emphasising the winning of new clients and work above existing clients.

From a skills perspective, two of the areas where differences can arise are:

General versus specialised skill sets of partners and professionals. Professionals with generalist skills can struggle when joining a practice where the partners and staff have specialised their skills. The generalists can be perceived as not having detailed enough knowledge in any specific area with there always being someone with more depth of skills to deliver any service coming in the door.

Overall experience and skill levels of partners and staff at each level. Non alignment can resulting in stress in assigning staff to projects and at promotion time.

Why Assess Organisational Fit?
Organisational fit is particularly important for professional service firms, such as legal firms due to the main assets and revenue generation of the firms being the people of the firm and their relationships with clients. The value of a merged or acquired firm can quickly depreciate with a drop in the morale or the loss of partners and staff and/or clients.

Assessing and understanding the organisational fit between potential merger partners and between each of the merger partners and the planned merged organisation enables:

- Realistic expectations with a greater understanding of partners of both firms as to what will change and what will remain the same,
- Input into financial negotiations and pre-merger requirements
- Identification of ‘deal breakers’ which result in abandoning the proposed merger,
- Self assessment and exit by incompatible partners or agreed exit of these partners by the firms,
- Identification of risk areas and mitigation strategies for the merger and integration,
- Input into planned post merger integration, such as how the organisation will be structured and training requirements,
- Greater post merger understanding that conflict is not personal and does not reflect resistance but may be based on some different values.

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All mergers are not the same when it comes to the importance of various factors of organisational fit. More organisational fit gaps can be tolerated when post merger integration is expected to be low than when it is expected to be high. For example, a firm joining as a regional representative of a second tier firm running a federated model where the offices run somewhat autonomously retaining their own profit share, processes and systems and with little interaction between the professionals of the firms can have some differences without much impact. However, where the merging firms are to be fully integrated, with structures, processes and systems combined and professionals co-located, organisational differences can have substantial negative impacts.

Law firms tend to already pay more attention to achieving organisational fit than other companies because
partners understand that people and culture are important to the success of the firm, as well as most having had prior experience with poor-fit mergers and acquisitions. Because partners vote for or against a merger, there’s also greater motivation to examine organisational fit, compared to other corporate acquisitions where shareholders not key managers decide many transactions.

Despite this greater level of attention, legal firms still participate in mergers where poor organisational fit causes substantial post merger issues. Some of the potential flaws in the assessment process are noted in the next section.

**Flaws in Organisational Fit Assessment**

Common causes of poor organisational fit include:

**Lack of merger experience:** For some firms, the merger being assessed may actually be the first merger for the firm resulting in the partners involved having no experience on which to base fit assessment and they therefore may not perform any fit analysis or perform it poorly.

**Failure to harness firm experience:** For large multi divisional and multi office firms many mergers are likely to be driven by a local business unit which may not have partners involved with experience in that type of merger. Across the firm as a whole, the results of merging small firms may be localised and not consolidated for the organisation to learn of the effects.

**Performing a different merger type:** The current merger may be very different than prior merger experience resulting in a different fit assessment challenge. For example, where prior mergers have been of regional legal firms to expand a firm’s geographic reach, the assessment would differ for a potential merger of another national firm or of a firm providing substantially different services.

**Failure to adequately involve those most effected:** This can happen when centralised management or a different part of the organisation than that which will be responsible for integrating the merged firm drives mergers. Affected partners’ votes may be overwhelmed by the votes of other partners in the firm.

**Strong social fit leads to neglect of other factors:** In some cases because the partners of the firms get along well on a social basis the detailed organisational assessment is neglected.

**Bias on identifying similarities not differences:** In the assessment stage the team assessing fit can easily be biased on identifying organisational similarities between the firms as opposed to differences, particularly when a strong strategic fit has already been established.

**Underestimating negative impacts of identified differences:** In some cases differences in the way firms operate are identified early in the process with the perception that both merger firms would benefit from the strengths of the other. However, on integration these differences result in substantial conflict over what prove to be deeply held beliefs and values. For example, prior to one merger, partners perceived that one firm could benefit from the other firm’s quality standards and technical competence while the other firm would gain from the first firm’s entrepreneurial profit driven approach. However, after the merger there was substantial conflict with partners from one firm seeing the entrepreneurial approach as sloppy and subjecting the firm to risk and partners from the other firm seeing the quality/ technical approach as bureaucratic and constraining the ability to earn profits.

**Failure to visualise the transformed merged firm:** Where the plan is to transform the merging firms into a totally different type of organisation it can be difficult for partners of the merging firms to visualise how the new firm will operate in order to self assess organisational fit with the new model. Even if there is reasonable organisational fit between the merging firms there may be a poor fit with the planned merged organisation. This is important as large national law firms merge to form new beasts, the international law firm, and as publicly owned legal companies continue to evolve and balance the needs of clients, professionals and external shareholders.

**Assessment is difficult:** Even the best efforts to identify organisational fit problems can sometimes miss cultural issues. This is due to the way the firm operates and its culture being taken for granted until integration when different approaches collide and highlight the differences and their implications. Another problem is that partners of the potential merger firms may be on their best behaviour during the courtship stage.

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**Improving Organisational Fit Assessment**

Legal firm mergers and acquisitions can be improved where both the strategic and the organisational fit are assessed pre-merger. Substantial organisational differences make significant integration of the merging firms extremely difficult and painful, limiting the amount of merger benefits that can be achieved. Assessing organisational fit pre-merger enables extremely poor fit mergers to be abandoned and appropriate integration planning and preparation when non-deal breaker differences are identified.

There are a number of actions that can be taken to assess organisational fit in order to reduce the risk of a poor merger and to prepare for areas of organisational difference. These actions include:

- Put in place processes to capture learning from merger fit assessments and to seek input from partners throughout the organisation with experience of similar mergers.
- Ensuring that assessment is performed regardless of how good the relationship between the partners of the two firms is.
- Documenting and comparing how each firm operates in terms of the attributes of structure/ systems and people fit mentioned earlier. Compensation plans and internal performance measures are crucial inputs into this activity. Highlight and consider the implications of differences identified. Are there any deal breakers?
- Ensure that the fit assessment actively focuses on identifying differences and that the implications of differences on how the firms and people operate day to day are carefully considered.
• Involve partners from the area into which merged firm will be integrated in analysis of people fit. Consider giving these partners veto right before going to a vote of all partners. An exception to this may be if the firm is poorly represented in an area and seeking to merge with a much stronger firm in that competency.

• Provide plenty of opportunities for partners of both firms to interact pre merger vote. Consider working together in an alliance to test organisational fit before moving to a full merger.

• Determine major integration decisions before the merger is completed. This enables better decision-making in the vote and creates realistic expectations for the integration stage.

• Ensure the partners of the other merger firm are well aware of the changes that will take place and what they are getting themselves into. Particularly when a very large and a small firm are merging and most change will be for partners of the small firm. The merger can be just as disruptive if your merger partner has poor assessment processes.

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