EVALUATING

MERGER OPPORTUNITIES

A MANAGED PROCESS

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Law firms stumble among potential merger partners with little but "gut feel" to guide their decision. A simple evaluation process permits law firm leaders to look at a merger from a variety of perspectives. The result is a judgment based on what the combined firm brings to the market rather than a comparison of two separate firms.

For many law firms it seems there are opportunities to merge everywhere they look. Indeed, some are approached so often that it becomes difficult for them to differentiate between their suitors, much less evaluate competing opportunities. The merger process is akin to "serial blind dating;" constantly being set up with people you don't know, lots of awkward conversations, very little romance and often a frustrating end.

Law firms talk about the test of whether a merger makes sense being if "two plus two equals five." While this standard makes a great sounding catch phrase, it doesn't really work as a practical tool in sorting through merger opportunities. When a law firm is trying to evaluate a possible merger, quantitative issues such as comparative profitability and partner compensation are balanced by subjective concerns about values and culture. Somehow, short-term considerations of a merger's impact on a firm's clients and attorneys must be weighed against long term positioning in the legal marketplace. Making matters worse, there are no real benchmarks for measurement. How can we decide if two plus two equals five when we don't know what five looks like?

At issue is whether a merger advances the strategic objectives of both firms without adversely effecting their culture or profitability. What is needed is a means of evaluating a potential consolidation from different perspectives. How does a merger appear to the firms' respective partners? What will be the reaction of the firms' clients? How will the marketplace receive the new practice strengths and geographic locations resulting from the merger? What happens to the overall quality of lawyers and clients after the merger? And, even if the merging firms created a checklist of all these items, how can they weight them against one another?

One might quickly argue that "profitability is the only measure of a successful merger." Profitability is, of course, the primary reason for any business activity, including a merger, but it cannot be the *only* measure. Suppose that firm A has net income per partner of $400,000 and firm B has net income of $300,000 per partner. If the two firms were to merge, the net income of the combined firm would be less than firm A and more than firm B. The only way profitability could immediately improve is if some fundamental change occurred as the result of the merger such as a new revenue stream, a dramatic expense savings or a complete change in the leverage structure.

In fact, the primary reason driving most mergers is to gain some unquantifiable advantage that will, in the long term, yield higher profits for the combined institution. Therefore, the only way firms can decide if a merger makes sense is to evaluate whether it significantly advances their vision and strategic objectives. Since these strategies are, presumably, designed to increase profits, their accomplishment should, by definition, increase profitability.

If law firms had a means of weighing all the issues involved in a merger, they could legitimately compare merger opportunities against the values and strategies of both firms. Evaluating merger opportunities is an ideal use of something called the *balanced scorecard.*

THE BALANCED SCORECARD

The balanced scorecard was created for corporations to measure their manager's implementation of the organization's vision and strategies in day-to-day operations. It forces management to look at performance from a number of perspectives in addition to financial results. With a little tweaking, the balanced scorecard is a great yardstick for use in evaluating a merger opportunity in relation to a firm's vision and strategic objectives.

Of course, this assumes the law firms involved in considering a merger do indeed have a vision and a strategy for how to achieve that vision. In truth, we know that most firms do not have much of a vision beyond vague statements about quality and profitability.

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PERSPECTIVES

There appear to be four primary perspectives from which to view a law firm merger.

- **Profitability.** This is the perspective of the *owners,* or shareholders, who are seeking a specified financial return. Their issue is whether the potential for an upside profitability increase is greater than the downside risk of profit decrease. Unlike corporations where shareholder value is the overriding criteria of success, law firm partners have interests in a merger from perspectives other than profitability—but profit plays a dominant role.

- **Values.** This is the perspective of the *stakeholders* —the people who come to work at the firm everyday— partners (who have a dual role as stakeholders and shareholders), associates, staff, as well as vendors and clients (who have a dual perspective as stakeholders and members of the marketplace). Culture is a major issue for law firms but comparative cultures usually get glossed over in favor of economics during merger discussions. Therefore, the degree to which the firms' respective operating strategies deal with compensation systems, associate retention, how people treat each other and similar matters are clearly measures of how stakeholders will view the merged firm.

- **Capabilities.** This is the perspective of the *marketplace.* How do clients, potential clients, potential lateral and law school recruits and competitors view the merger? Strategies that involve building practice areas and expanding geographically are largely designed to influence how the marketplace views the combined firm. It is the perspective of the marketplace and whether it understands and accepts the rationale for the merger that dictates whether a merger makes sense.

- **Asset Base.** This is the view of the *accountants* and *bankers.* Would the merger enhance the asset base of the

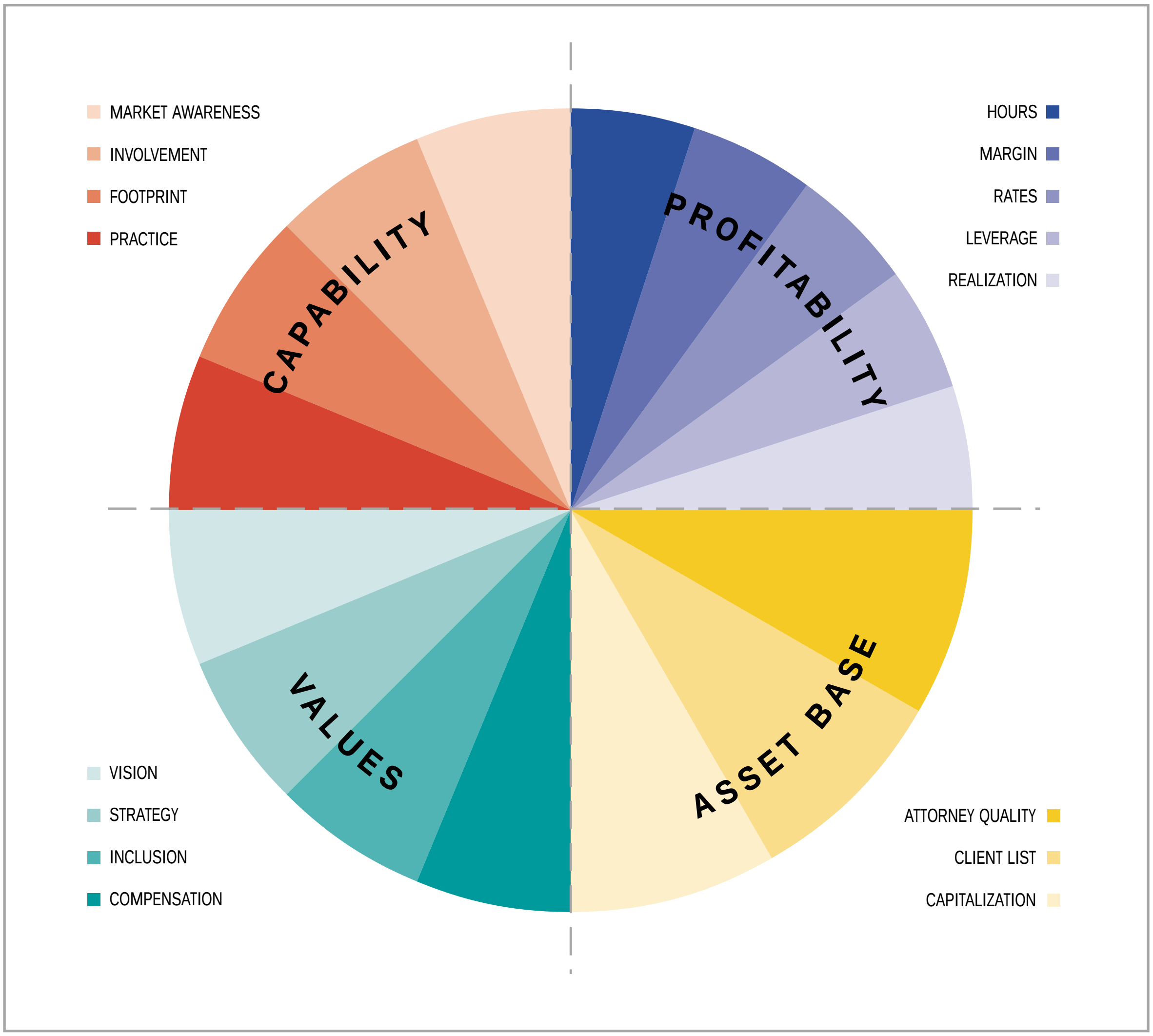

FIGURE 1: THE MERGER EVALUATION BALANCED SCORECARD

firms? Does the merged firm improve the quality and depth of both firms' lawyers and clients? What does the merger do to the combined firm's capitalization and its ability to create debt in order to grow and launch strategic initiatives?

Appreciating that these four perspectives exist is not sufficient. Effectively evaluating a merger requires understanding the factors that contribute to each perspective and having an actual score card on which to perform the evaluation.

CAPABILITY

The marketplace takes into consideration four primary factors in its perspective of a law firm merger: *practice, footprint, involvement* and *marketing.*

• **Practice.** Practice is the marketplace's view of what the merged firm does and how well it does it. Is the firm's practice viewed as primarily litigation or corporate transactional? Is it full service or a boutique? Do any practice areas approach preeminence in the marketplace? Evaluating a practice is a mixture of reality and perception. For example, a number of large firms began as insurance defense litigation firms, entering new areas of practice over the years to build full-service firms. Today these firms may handle little or no insurance defense work. Yet the perception in the legal marketplace may still be that the firm is primarily insurance defense or general litigation.

The same is true with issues of preeminence. A firm whose claim to fame is being recognized as the premier employment law firm in a city will be viewed as a boutique. People may understand that this firm does other things but will label it by its most outstanding feature. By the same token, if a firm has two or more areas of significant preeminence, say labor law and intellectual property, the marketplace will apply the preeminent label to the entire firm.

- **Footprint.** This refers to whether a firm is viewed as local, regional, national or international. While there may be some difference between the perception and the fact of a firm's footprint, that difference is rarely as broad as it can be with the firm's practice. Why? Firms do a much better job of communicating *where* they have offices than *what they do* in those offices.
- **Involvement.** Involvement is the marketplace's recognition of the degree to which a firm is involved in the community, bar activities, politics or other pursuits outside the legal profession. The business community and, to some extent, the legal community tend to have a favorable perception of the powers, access and dominance of a firm when its lawyers have a high degree of civic involvement. It is important to distinguish between a firm with one partner who is actively involved in lots of activities and a firm with heavy across-the-board involvement.
- **Marketing aggressiveness.** This is the manner in which the firm develops new business. Would the marketplace characterize the firm as being made up of aggressive lawyers who constantly hustle business, or as a white shoe firm that waits for business to come in "over the transom."

FIGURE 2 **MERGER EVALUATION BALANCED SCORECARD: CAPABILITY**

	FIRM A	FIRM B	ANALYSIS
PRACTICE	Strong IP practice in Washington but not recognized in other cities. Strong product liability defense practice is all locations. Viewed primarily as a litigation firm.	Strong public finance practice in NYC. Viewed as a bond boutique despite strong general corporate practice.	Public finance practice is free standing and does little to benefit from other practices.
FOOTPRINT	Regional firm with offices in the Great Lakes region and a small presence in San Francisco.	Local firm in NYC.	Addition of NYC creates a national image.
INVOLVEMENT	Little general involvement. Involvement not recognized or compensated.	One partner heavily involved in NYC politics. Source of bond business.	Involvement not an issue with either firm.
MARKETING	Marketing budget 2.3% of revenues. Heavy entertainment and advertising. Few direct client presentations. Low aggressiveness.	Marketing budget .9% of revenues. Business built through personal relations and campaign contributions.	Neither firm particularly aggressive. Neither firm will impact the other.

Because marketing aggressiveness is an external function, the marketplace perception is generally identical to the fact. Therefore, statistics on marketing budgets, client presentations and even new clients developed can be used to compare two firms' relative aggressiveness.

See Figure 2 for a sample scorecard that compares two merger candidates on capability.

VALUES

Values deal with subjective issues that may often be termed as cultural. While there are wide ranges of factors that fall into culture, four are dominant: *vision, strategy, inclusion* and *compensation.*

- **Vision.** Vision represents the degree to which the firm has a clear self-image of what it is and what it wants to be. Having a strong vision usually requires having a visionary leader who actively communicates that vision in a clear and consistent manner. In evaluating a potential merger, vision is perhaps the most important area of compatibility, yet it often gets glossed over in favor of profitability. The test of vision is not what a firm's mission statement says, but how well the vision has been communicated to the firm's stakeholders, how well they accept the vision and whether the firm's actions are consistent with the vision.

- **Strategy.** Strategy is whether the firm has plotted a course of action to achieve its vision. An amazing number of firms have an aggressive vision of the future but no clue abut how to fulfill that vision. Whether two firms considering a merger have strategies, and how one strategy relates to the other, is an important point of evaluation. For example, two firms may have the same vision of growing into a "mega firm," but one firm may expect to do so by merging with firms across the country while the other firm plans to grow through lateral and law school hiring from within its existing offices.

- **Inclusion.** Inclusion is often viewed as a "touchy-feely" issue, but it can represent a huge cultural crevasse between law firms. In large measure, inclusion refers to the openness that is present in a firm—how well it shares information and goals with its stakeholders and the degree to which stakeholders feel they have a voice in the firm's destiny. Inclusion is sometimes characterized as democracy versus autocracy and, indeed, that is a significant aspect of inclusion at the partner level. Sharing objectives, strategies and key financial information at the associate and staff level, however, is equally significant.

- **Compensation.** This refers to the criteria on which partner compensation is set, who establishes compensation and whether compensation information is shared among all partners.

A sample scorecard relating to values is shown in Figure 3. (*Note:* Culture and values compatibility is of such importance that I always recommend participating in a cultural inventory before firms move too far in a merger discussion. This involves a survey given to key leaders in each firm that provides a graphic comparison of the two firms' cultures. At issue is not whether one's culture is better than the other's, but rather to create an agenda for open discussions about cultural issues.)

"The results of the scorecard provide a blueprint to help a firm identify and target potential merger candidates. This empowers a firm to proactively seek out merger opportunities as well as react to those presented."

ASSET BASE

The asset base is the factors that should be represented on a firm's balance sheet: the *quality of its lawyers, the quality of its clients* and *the firm's capitalization.*

- **Quality of lawyers.** This deals as much with perception and reputation as it does with actual quality. Two firms could compare class rank or even LSAT scores, but that would only measure academic excellence. Quality is in part intellect and in part the ability to accomplish clients' objectives. Since these are very difficult to measure without extensive client surveys, the issue of lawyer quality only becomes an issue in the extremes. Still, a firm filled with top-of-the-class Ivy League graduates might find vast cultural differences with a firm of "street fighters."

- **Client list.** Comparing client lists is critical not only for evaluating the presence of actual or potential conflicts among clients, but also the name recognition value of each firm's top clients. If the 10 largest clients are Fortune 100 or high-growth tech companies, the market, including recruits, potential clients and future merger candidates will view the client list as a major asset. If the client list is weighted with insurance companies and banks, the list is less valued. This is not to say that firms with different types of clients can't merge. The question posed is whether the combination enhances or dilutes the perceived value of each firm's client list.

• **Capitalization.** This refers to the firms' net equity per partner. Firms that are thinly capitalized and highly dependent on debt will have a difficult time consolidating with a more heavily capitalized, debt-adverse firm.

A sample balanced scorecard for issues involving the asset base is shown in Figure 4.

PROFITABILITY

Most merger discussions devote the bulk of time to profitability. In large measure, the comparative profitability of two firms expressed in terms of profit per partner is less important than the factors that create that profitability.

From the work of David Maister we know that net income per partner is based on the following formula:

Net Income Per Partner = Hours X Rate X Margin X Realization X (1+ Leverage)

Where:

- Hours is the total hours worked divided by the weighted average number of timekeepers
- Rate is the total fee revenues divided by the total billable hours
- Margin is the amount available for distribution to partners divided by the total revenues
- Realization is the total fee collections divided by the total value of time worked.
- Leverage is the weighted average number of non-equity timekeepers divided by the equity timekeepers

• **Billable hours.** Billable hours can be the source of incredible post-merger friction if differing work ethics are not addressed early on. While it may be easy to say that differences can be handled through compensation differen-

FIGURE 3 **MERGER EVALUATION BALANCED SCORECARD: VALUES**

	FIRM A	FIRM B	ANALYSIS
VISION	Wants to be recognized as being national and general practice. Beyond that, no strong vision.	Views itself as being one of a handful of premier capital market firms in the country.	No compatibility of vision. Need to figure out what each side wants out of a merger.
STRATEGY	Grow revenues as rapidly as possible by the additional of laterals and mergers.	Be extremely innovative in creating financing vehicles and using political contacts to sell them in secondary capital markets (Chicago, San Francisco, Dallas, Boston).	Although the firms lack a compatibility of vision, there is a synergism of strategy. Neither strategy conflicts with the other.
INCLUSION	Highly democratic. Associates are on committee and receive full financial statements. Strong communication to associates and staff on a regular basis.	Reasonably democratic within partnership. Strong committee structure. Little inclusion of associates or staff in decisions or communications.	Discussions demonstrate that Firm B is willing to become more inclusive and adopt Firm A system.
COMPENSATION	Set by executive committee and approved by partnership vote. Primary basis of compensation is personal working attorney revenues with some recognition of originations. Partners know each other's compensation.	Set by three-member compensation committee after interviewing all partners. Profits from a partner's practice are sole basis for compensation. Partners know each other's compensation.	Completely different basis for compensation. Difficult to get Firm B slotted into Firm A's system.

tials, major problems await if lawyers in one firm average a couple of hundred billable hours more per year than lawyers in the other firm.

- **Billing rate.** Rate differences often reflect geographic differences, but differences also may point out possible incompatibilities regarding practice sophistication and pricing aggressiveness.
- **Profit margin.** Profit margin is a function of expense control and work style. While partners like to devote large portions of merger discussions to cost containment, rarely are there significant differences in margin that cannot be justified by geographic location and multi-office costs.
- **Realization.** Realization is a measure of institutional business practices. Firms with routine write downs or with slow-to-bill and slow-to-collect lawyers tend to be less entrepreneurial in their views on the practice of law as a business. Law as a profession or a business is difficult issue to reconcile within one law firm, much less two.
- **Leverage.** This is the number of non-equity timekeepers who support equity partners— a huge profit driver that can also demonstrate cultural and practice differences.

A sample scorecard that measures profitability is shown in Figure 5.

THE FINAL SCORE

The balanced scorecard cannot be used to present a quantitative evaluation of whether a merger is a good or bad idea. It can, however, force firm leaders to look at a potential merger from perspectives other than their own. In addition, the balanced scorecard presents a template on which to consider a merger and present the issues to the firms' partners.

The results of the scorecard also provide a blueprint to help a firm identify and target potential merger candidates. This empowers a firm to proactively seek out merger opportunities as well as react to opportunities presented. What's more, running the balanced scorecard in reverse—profiling

FIGURE 4 **MERGER EVALUATION BALANCED SCORECARD: ASSET BASE**

	FIRM A	FIRM B	ANALYSIS
LAWYER QUALITY	Strong academic preparation. Recognized as having top quality lawyers and superb trial lawyers. Mainly Big 10 graduates.	Strong academic preparation. Recognized as being brilliant and innovative. Mainly NYU and Columbia graduates.	Both firms have strong academics and reputation for top quality lawyers.
CLIENT LIST	Fortune 500 client list. Provide single practice area to clients. Few general counsel representations.	Banks and investment bankers. General counsel relationships with start-ups.	Both firms have valuable client lists. Lists enhance each other if cross-selling can be performed.
CAPITALIZATION	Heavy capitalization ($100K to $325K). Debt per partner is $28K, all non-recourse.	No permanent capital. Heavy cash flow financing. Debt per partner is $228K, half of which is personally guaranteed by the partners.	Major problem. Partners in Firm B. must come up with an average of $228K each to pay off debt plus make capital contribution to Firm A.

FIGURE 5	**MERGER EVALUATION BALANCED SCORECARD: PROFITABILITY**		
	FIRM A	FIRM B	ANALYSIS
PROFIT-PER-PARTNER	$339,000	$398,000	Firm A profits are trending upward at 15% per year. Firm B profits are declining due to decline in capital markets.
HOURS	Partners average 1700, associates 1950.	Hours not kept because billing is a percentage of the deal. Effort is estimated to be in excess of 2000 hours for all timekeepers.	Partners in Firm B have a much stronger work ethic than in Firm A. This may be masked by B's not keeping hours.
RATES	Partners average $325 ($225 to $500); associates average $185 ($145 to $220).	No hourly rates. Revenues divided by estimated hours yields an effective rate of $625.	If firms can accept Firm B not keeping hours, this is not an issue.
MARGIN	38%; operating costs of $166K per attorney.	55%; operating costs of $193K per attorney.	Given difference in revenues and cost of operating in NYC, expense structures are compatible. Little opportunity for savings through economies of scale.
LEVERAGE	1:1	4:1	Firm B uses few associates due to the sophistication of its work. It recognizes the need for more leverage.
REALIZATION	98%; 2.1 months of WIP and 2.6 months of AR. Partners tend to be lax about billing and collections until the end of a year.	93%; fees billed and paid at closing. Write offs on deals that fail to close.	Issue of whether Firm B partners will tolerate Firm A's slow billing and collection habits.

the strategies against which the firm would appear most attractive—allows a proactive firm to target those firms most likely to be receptive to a potential merger.

Like most management tools, there is nothing dramatically new about the balanced scorecard. It does, however, impose some structure in the consideration of professional firm mergers. Given the traditional alternative of entering into merger discussions then backfilling a strategy to justify a consolidation, the balanced scorecard is a tool that can be quite valuable.

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Robert S. Kaplan of the Harvard Business School and David P. Norton, President of Renaissance Solutions, a consulting firm, created the concept of a balanced scorecard. Kaplan and Norton are the authors of several articles and a book on the balanced scorecard. Their article "Using the Balanced Scorecard as a Strategic Management System" (*Harvard Business Review,* January-February, 1996), presented the basic foundation for this article.