

Partnership

An ALM Publication

WWW.NYLJ.COM

MONDAY, MARCH 21, 2016

To Merge or Not to Merge?

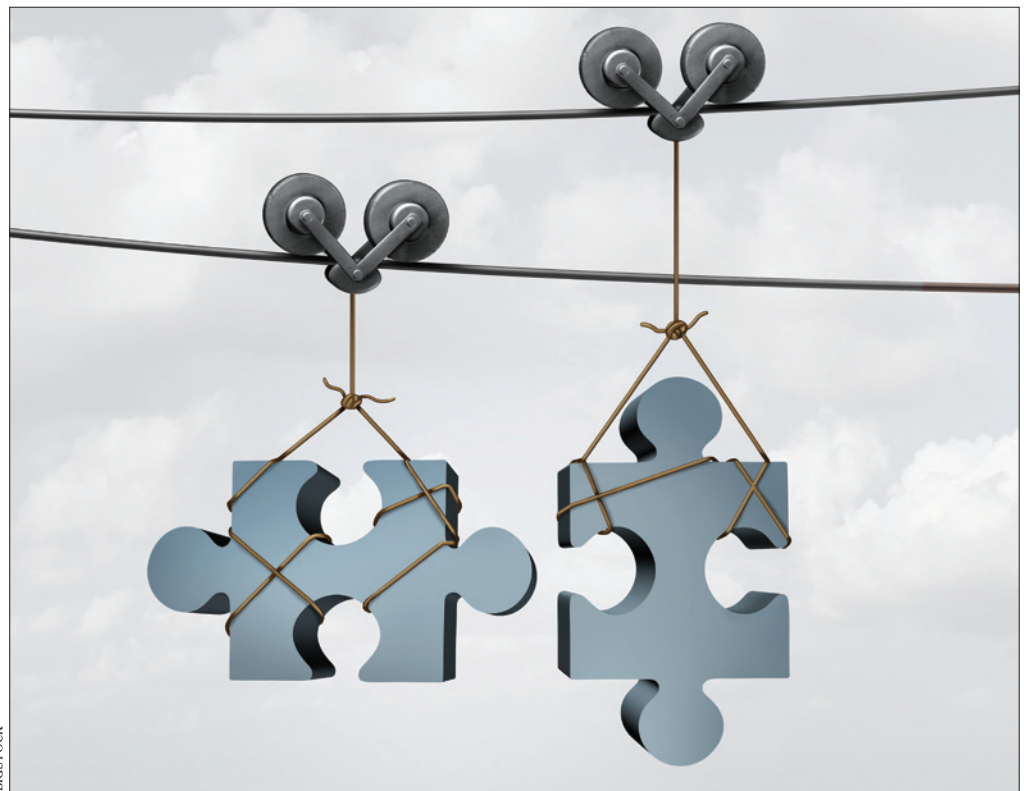
BY RONALD H. SHECHTMAN

The “one-percenters” that we are hearing so much about in this year’s primary election campaigns also have an analogous place in current law firm economics. The rich are getting richer, and most others are struggling to hold their own.

Thus the law firm surveys tell us that the industry is growing, but that much of the growth is concentrated at the top, largest firms. The great majority of the AmLaw 200, we are told by the surveys, face stagnant or lowering demand, increased pressure on rates, and the greatest merger activity than ever before. As of last November, Altman Weil reported a record of 79 mergers in 2015, the largest number since they starting keeping track.

There are also the cases of Dewey & Leboeuf, Howrey and Dickstein Shapiro and others that never really made it to merger. We know that many of those transactions called “mergers” of law firms actually mask one firm picking at the carcass of another, sometimes calling the process a merger, and other times simply taking large groups of one firm, and leaving the other lawyers to dissolve their firm or merge into another law firm that will sharply reduce their ranks in short order.

A Jan. 19, 2016 New York Law Journal article reported that “boutiques and midsize firms competing with large firms are under increasing pressure to merge or grow in size.” But the demise of regional, mid-sized firms has been greatly exaggerated. The evolutionary theory that cited them as dinosaurs has been challenged by not only the continuity of firms like Pryor Cashman, but also by other mid-sized firms thriving in the current law firm economic environment where clients are demanding value for their legal fee dollars. Pryor Cashman has



reached record revenues and profits since the Great Recession. Why do mid-sized firms have a secure place in the law firm market?

The Entrepreneurial Platform

How does a young entrepreneurial lawyer develop her practice in BIG law? We have just learned that the \$1,500 line for partners’ rates has been crossed. Even more harrowing for the lawyer looking to develop her practice are the rates of junior associates billing at \$500+ per hour along with senior associates in the \$700-800 range. Meanwhile as the biggest law firms are getting BIGGER, that small or medium size transaction has actually become a nuisance, incapable of supporting the leverage and billing that Big Law economics require.

One Big Law, lateral candidate I met told me that he had to turn down the opportunity to do the leasing for a number of large Manhattan office buildings. The requirement of his firm that he produce leverage of three-to-one (i.e., three hours of associate time for each one of his), as well as his firm’s rate structure, made the representation impossible.

In fact, when it comes to large firms, one “expert” consultant told me that the rules of economy of scale are turned upside down. As law firms grow and multiply offices, the attendant costs of increased management and infrastructure to meet the new demands of more lawyers and offices overcome the efficiencies. Moreover, to compete in the world of the AmLaw classified firms, meeting the salary and bonus structures for associates and even support staff that seem to be forever escalating mandate

RONALD H. SHECHTMAN is Pryor Cashman’s managing partner and chair of the firm’s labor and employment group.

rate and leverage requirements that make the lot of the entrepreneurial lawyer a hard one.

Thus I am seeing more and better lateral partner candidates than ever before in virtually every practice area. They are eager to get out of their silos, from which they are unable to do work that is outside of their ever increasing super specialization. They are unable to get the firm's support to use others' expertise because those others are engaged in representing the firms' mainstay clients, rather than start-ups or mid-sized businesses or even individuals whose matters are not large enough or who cannot afford the tariffs of Big Law.

A few years ago we recruited a young lawyer from a multi-national firm based in Chicago. He was growing a securities practice, working with small underwriters in financing new ventures, including companies in China. After giving us serious consideration, he decided to join the New York office of a Big Law firm based in California. He told us that their office in China was a decisive factor.

About 18 months later he called and asked if the door was still open here. He said he realized that he was in the wrong place to grow his practice. He described a billing problem with a client involving a small six-figure fee. He needed to get an adjustment in the billing to secure the deal. He sent memos to the appropriate players, including management in California. It took two weeks to get a response, and the client had moved on. He is now the largest originator in our corporate practice group.

The Dynamics of a Mid-Sized Firm

While many entrepreneurial lawyers recognize the advantages of the mid-sized platform for growing business, many are concerned about the stability and security of these firms. Many have failed or opted for mergers into Big Law where their cultures have been lost.

Generally those failures fall into three categories. First, a firm becomes overly dependent on a small client base or a particular industry, and the firm suffers deeply when it loses its major client, or the industry on which it is focused experiences a serious downturn. Second, a firm becomes overly dependent on a small core of originators, and one or more chooses to leave the firm, maybe changing careers or opting for another platform. Third, a firm is led by a small group of 60-something year old (usually) men who are growing tired of carrying the firm on their backs. They opt for a merger into Big Law that assures them of a remunerative exit strategy, while much of the rest of the firm will wither away in short order.

At Pryor Cashman, the firm's client base is spread out among a variety of originators in many different practice areas. No client has represented more than 5 percent of the business of the firm for many years. The diversity of the client base, like that of the originators, is a key factor in the stability of the firm.

Over 40 percent of the partners at Pryor Cashman originate more than \$1,000,000, and more than half of the partners originate more than \$500,000. While those origination numbers may not move the needle in Big Law, they create a business base that allows Pryor Cashman to compete with much of the AmLaw 200 on both revenues and profits per lawyer. The diversity of the base of originators provides stability, insofar as the firm is not vulnerable to the loss of business or departure of a few key partners.

While mid-size firms typically do not have the institutional stability or longevity of many of the AmLaw 200 firms, we have learned too well that sometimes that stability is illusory (cf., Dewey & Lebeouf; Howrey and Thelen). Management of the mid-size firm, however, can maximize its own stability with an ongoing focus on revitalizing the partnership with new partners with upside futures and maintaining a broad base of originators and clients. At Pryor Cashman, one-third of the current partners entered the partnership since 2007 either by promotion or lateral entry. The effect of these new partners is to keep the partnership young and to invest in new sources of business with a commitment to the future.

Lateral Recruitment

Legal industry experts often write about the perils of lateral partner recruitment. We hear varying numbers, some saying that batting .300 is the norm or that .500 should be considered successful. At Pryor Cashman we have batted above .800. Why the difference?

In the last six years we have grown from about 125 to 145 attorneys. While hardly an explosion, this expansion has been purposeful. We have hand-selected attorneys to join our ranks based on practice symmetry, personality and cultural fit. Management must be dedicated to the recruitment of laterals who can leverage the mid-sized firm platform to grow current work and attract new business.

The attractiveness of the firm is in the very fact that it is not Big Law. Many of our recruits who have come from AmLaw firms, purposefully chose Pryor Cashman for its lack of bureaucracy, the ability to grow their practice and the competitive pricing structure.

Recruiters tell me that Big Law generally sets a threshold of \$2,000,000 of business for a lateral recruit. We usually have no threshold. Instead we focus on the recruit's history of developing business (beyond a handful of clients) and try to measure his ability to fulfill his potential for business development. While I would like to take credit for extraordinary perspicacity in this process, I am fortunate to have an Executive Committee that participates in all lateral partner recruitment. We only act by consensus, and the collective judgment of the seven of us has been impressively successful. We have seldom been disappointed.

But a key element of our recruitment success involves the structure of our deals. We do not offer large guarantees or signing bonuses. Nor do we offer equity to start. With partners with a significant book of business, we promise a bigger payday that exceeds their current income if they can meet what they represent they have in business, and a still bigger payday if they exceed it. But along the way to meeting their expected level of originations, the recruit is sharing the risk with the firm. The recruit who eschews the risk, despite a generous upside, gives us a "tell" that we welcome. I am sure that we have lost some strong lateral recruits by this compensation model, but those losses are offset by the success that we have had in sharing the risk—and the rewards—with our recruits.

To Merge or Not to Merge?

I have no categorical response to this existential question that surely most mid-size firm partnerships face. I used to receive inquiries almost monthly before recruiters and consultants understood that the partners at Pryor Cashman want to preserve a culture in which the partners know each other and function without bureaucracy. Inquiries still come, however, from New York AmLaw 200 firms, as well as from firms around the country.

The partners at our firm have prospered in the current environment where clients have become increasingly value-driven in their quest for legal services. At the same time, they feel they have attained a meaningful level of stability and security.

Although no business can withstand all storms or unanticipated challenges, the fallacy is that Bigger is better. As Felix Oberholzer-Gee, a professor of business development at Harvard Business School and a law firm consultant, concluded in the *American Lawyer* last November, "law firms can't grow their way to prosperity." The focus, he asserts, must be on growing the bottom line and not being fooled by promises of growth in the top line.

So a merger is not an alternative merely to attain growth, if growth in the bottom line does not correspondingly follow. But merger or strategic acquisition cannot and should not be ruled out when it can form a combination that has new and better capability, matched by profitable business opportunities. In other words, an open mind is an enlightened one. No generalization fits in assessing any combination of lawyers or firms.

We believe that a mid-sized firm not only has a place in this market, but that we enjoy many advantages. That is what our partners say by their longevity at the firm. Size is not all that matters.