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for mergers in 2024

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LAW FIRM MANAGEMENT

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3 critical considerations for mergers in 2024

After a decline during the pandemic years, 2022 and 2023 saw an uptick in law firm merger activity — and the trend has so far continued into 2024. A merger or acquisition is a major step, though, so law firms thinking about following suit should carefully weigh several factors before moving ahead.

RISING ACTIVITY

The level of law firm merger activity in 2023 grew slightly over the previous year. While large firm mergers tend to make the legal news headlines, nearly 70% of the mergers involved at least one firm with only five to 20 attorneys.

And in 2024, activity increased 25% in the first quarter compared to the same quarter in 2023. Firms with five to 20 attorneys participated in 65% of the mergers, versus 59% in the first quarter of 2023. If the numbers continue the trend, law firm mergers will increase again this year.

FACTORS TO PONDER

The increased law firm merger activity shouldn't obscure the fact that many attempts end up failing.

To avoid a similar fate, be sure your firm evaluates the following factors early in the process.

1. THE STATE OF THE FINANCIAL REPORTING

The prospects for a proposed merger are dim if either side doesn't have its financial house in order from the start. You can expect the other firm to want to examine at least three years of financial statements (and vice versa), as well as projections with support for assumptions. For example, they'll want to know if the projections are built on assumptions related to billing rates or fee arrangements that will be altered in the new firm.

Debt is just one of the areas you should scrutinize. Find out if it's related to asset purchases or other spending. Determine if debt limit policies are in place and whether any debt covenants will be affected by a merger. You also should dig into off-balance sheet items like unfunded retirement plans.

Expenses require a drill-down also to determine whether the two firms take a similar approach. For example, is one firm markedly more



THE VALUATION COMPONENT

Valuations are an indispensable part of merger transactions. If your law firm anticipates a merger in the future, it's helpful to understand how it'll be valued.

Appraisers generally employ the following methods when valuing a law firm:

Discounted cash flow. The value is based on the firm's future financial performance. It uses historical financial data to predict future cash flows and applies a growth rate to discount the result to net present value.

Comparable transactions. The value is based on the sales of similar firms in terms of geography, practice areas, size and financial performance to estimate value. This method can be difficult to apply to law firms because truly comparable sales aren't common.

Rule of thumb. The appraiser applies a multiplier (generally, 0.5 to 3.0) to the firm's average gross fee revenues or net income over the past five years or so. The multiplier represents the likelihood that revenues will remain steady or climb going forward.

extravagant in terms of items like client entertainment and travel per diems? And some firms are more interested than others in projecting an image through swanky offices and the like.

2. CULTURES AND VALUES

Aligned cultures and values have always been an important ingredient in a successful merger. Clashes can damage morale and lead to silos or worse within the new firm. But the term "culture and values" has a broader definition than in the past.

It now encompasses matters such as diversity, equity and inclusion (DEI). Some firms and clients increasingly are prioritizing DEI, but others are strongly opposed to the concept, making it an issue worth exploring in advance.

Another concern is the approach to cybersecurity. Even now — when costly and reputation-damaging data breaches are regularly revealed — not every law firm has embraced an organization-wide culture that recognizes and takes the necessary steps to combat cyberthreats. This stance can present a problem when it comes time to integrate systems, among other things.

Bear in mind, though, that cultural differences aren't necessarily insurmountable. A merger can give a firm the opportunity to take a new position or approach.

3. PRACTICE AREAS

The desire to expand practice areas frequently is the motivator for a merger. But merging firms must ensure that the various areas of the combined firm will complement each other and lead to cross-selling and up-selling opportunities with the firms' respective clients.

This requires close review of both firms' existing client lists, with an eye toward providing a one-stop shop for all their needs whenever possible (and preventing conflicts). You also should assess the likelihood of the talent (including non-attorneys) in the target practice areas staying with the new firm.

DON'T GO IT ALONE

A good merger transaction experience takes a team. It is understood that you'll need accounting, tax and legal advisors. Also be prepared to retain banking, real estate, insurance and valuation experts. (See "The valuation component," above.) •

Strike the right balance

FAIRLY COMPENSATING YOUR MANAGING PARTNERS

Should you be paying your managing partner more than your top rainmakers? How much is enough? In this tight labor market, attracting, hiring and keeping someone who can successfully balance managerial duties with client representation is a must. Here are some incentives to help you do just that.

FINDING THE RIGHT WAY TO PAY

Many law firm managing partners perform the job full-time and don't do client work, making compensation fairly straightforward. But what about part-time managing partners, who've given up at least some client work to perform nonbillable management tasks?

Compensating these partners can be tricky. It doesn't make sense to compensate such individuals based solely on billable hours, revenue generated or other methods used to evaluate full-time practicing partners. Two methods to consider are:

1. A flat fee plus percentage. Here, your firm pays a set amount for management duties, such as \$100,000. Then you can add a percentage of

profits based on hours, revenues, client origination and other metrics.

Effective leaders usually are credited with having “vision” and inspiring confidence — neither of which is easy to measure.

2. A mix of objective and subjective criteria.

This method considers the partner's management and client-related contributions. Compensation is based on a variety of factors, depending on what your firm values, the percentage of time spent managing vs. working with clients, and how successful the partner is at meeting personal and firm objectives. Everything from your firm's financial health to the managing partner's business origination could be a factor. This option generally works best because it allows firms to reward their managing partner not only for doing the job, but for doing the job well.

LOOKING AT IT OBJECTIVELY

To ensure everyone knows what to expect, your managing partner should work with your compensation committee to allocate percentages to nonbillable management and billable client work. For example, the partner may decide he or she needs to devote 75% to management and 25% to clients. In this case, the 25% would be evaluated the same as the client work of other practicing partners. The remaining 75%, however, would be assessed on a variety of factors.

Objective criteria might include your firm's financial performance, as measured by per-partner performance or revenue growth, and



achievement of goals, such as implementing an IT upgrade or recruiting a lateral partner to head up a new practice area. Ask the partner to set goals that align with your firm's strategic objectives to help make this assessment easier.

UNDERSTANDING THE SUBJECTIVE FACTORS

Most criteria are likely to be subjective. For example, effective leaders are usually credited with having "vision" and inspiring confidence — neither of which is easy to measure.

Depending on your firm's priorities, your managing partner may be responsible for business and marketing strategies, including growth through mergers and geographic expansion. Other responsibilities may include:

- Client satisfaction,
- Public relations and business and legal community outreach,
- Internal operations, loss prevention, internal controls and ethics,

- Manager and partner performance,
- Human resources and employee benefits, and
- Firm morale and productive relationships between attorneys and staff.

Put such responsibilities in writing, recognizing that they may change over time as the partner adjusts to the role. Everyone should be on the same page about which duties are considered "part of the job" and which reflect extraordinary performance (usually financial achievements). In the case of the latter, you may want to pay a performance bonus separate from regular compensation.

PROOF IS IN THE PROFITS

If your firm focuses on compensating only rain-makers and large revenue-generating partners, you may lose those best qualified for the job. Properly compensating partners who perform the critical day-to-day work will keep your firm running profitably. •

Is a legal pricing professional right for your firm?

The days of the traditional fee model where law firms presented clients with a take-or-leave-it hourly or flat rate are long gone. Clients have become savvier about negotiating their fees, prompting a growing number of Big Law firms to hire legal pricing professionals. Professional input on fees isn't just for the behemoths, though. Here's what you need to know.

BIRTH OF A NEW PROFESSION

The so-called Great Recession of 2007 led to the increased prevalence of alternative fee arrangements (AFAs), as well as the beginning of clients treating legal services as another item

to go through a procurement process. As AFAs started to account for a large portion of firm revenues, law firms realized they needed professionals who could direct rate negotiations and coach firms through unfamiliar pricing strategies such as reverse auctions.

When the COVID-19 pandemic struck, legal pricing professionals stepped up to help preserve profitability for their firms by implementing strategic credit policies and equipping their firms to be proactive on AFAs. Although the pandemic has receded, higher cost consciousness is stubbornly hanging on, making a legal pricing professional a vital part of your team.



TOP TASKS

Today, legal pricing professionals play what may be a surprisingly broad role in their firms. Their reach extends far beyond simply setting rates and monitoring adherence. They develop pricing structures and systems designed to generate revenue (including the prevention of revenue leakage) and contribute to profitability. Legal pricing professionals also interact with clients more than might be expected, working to provide predictable costs that fit within the clients' budgets.

According to True Value Partnering Institute (TVPI), an accreditation body for the legal field, the top five activities for lead pricing professionals are:

- Developing pricing options,
- Analyzing and approving pricing requests,
- Evaluating historical client and matter performance,
- Developing and embedding pricing systems, and
- Negotiating directly with clients.

They also “follow the money” all the way through to billing and collection.

COMPENSATION

The lead pricing professional in a firm typically reports to the chief financial officer or chief

operating officer. In some cases, though, the pricing team might report to the managing partner or someone like the head of practice management or client value.

Such stature comes with a high price tag. A 2022 analysis from the TPVi found that total compensation for chief legal pricing professionals averaged \$571,300. Total compensation for a director was \$270,400 and \$114,800 for an analyst. The growth

rate was notable. Two years earlier, the chief pricing officers were approaching \$500,000 only at the top end of the range.

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Interestingly, higher compensation rates don't correlate with longer tenures. In fact, more than half of the lead pricing professionals had been with their current firms for fewer than five years, and 25% joined their firms within the past 18 months. The TPVi theorizes that the high level of mobility is responsible for the higher average compensation among less-tenured professionals. In other words, they presumably received a raise when joining a new firm. The competitive market for legal pricing professionals is likely another factor.

A RED FLAG

Do you regularly have clients questioning or complaining about their bills, possibly threatening to take their business elsewhere? If so, you should consider bringing on a legal pricing professional. •

Trends in the law firm marketplace

The *2024 Report on the State of the U.S. Legal Market* from the Center on Ethics and the Legal Profession at Georgetown Law and the Thomson Reuters Institute explains why the legal market in 2023 had an “encouraging but not outstanding year.” The report highlights the fundamental shifts in the marketplace over the past 15 years and considers the potential impact of artificial intelligence (AI), particularly generative AI.

CURRENT LANDSCAPE

The 2010s featured strong performances from transactional practices, such as mergers and acquisitions, real estate and tax. More recently, though, most of the growth has related to counter-cyclical practices that tend to run in the opposite direction of general economic conditions — think litigation, bankruptcy, and labor and employment law.

At the same time, law firm billing rates have rapidly climbed. In 2023, the report says, the rates clients agreed to pay for new matters grew by more than 6%, with every segment of law firms enjoying aggressive hikes in worked rates, similar to those experienced before what the report dubs the “Great Financial Crisis of 2008-2011.”

The generative AI revolution will happen whether individual firms get on board or not.

Profitability hasn’t increased at a similar pace, though. Many firms are dealing with drops in realization and productivity. The higher rates also are running up against persistent high growth in overhead expenses and increases in salaries and associate hiring. This is all on top of clients becoming more willing to transfer their work to less expensive firms to control their costs.



PROMISE AND THREAT OF AI

The report acknowledges that generative AI factors heavily when predicting the state of the legal industry in 2024 and beyond. AI has had a home in law firms for some time, but generative AI could have a “massive impact.” Earlier research by the Thomson Reuters Institute finds that attorneys are optimistic about the technology’s potential to enhance productivity and efficiency, although some skepticism remains.

That skepticism is understandable. After all, in 2023, two attorneys were fined for a ChatGPT-generated court submission that cited and attached fake cases. The judge said one of the fake cases “had some traits that are superficially consistent with judicial decisions” but also included legal analysis that was “gibberish.” At this point, it’s wise to exercise caution regarding the use of generative AI in the actual practice of law (versus, for example, for marketing tasks).

POSITIONED FOR THE FUTURE

As the report notes, the generative AI revolution will happen whether individual firms get on board or not. The firms that can quickly pivot in response to it and other evolving changes in the marketplace are the most likely to both survive and thrive in the future. In the long run, clinging to the traditional ways could prove a death knell. •



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