O
ver the last decade there has been a wave of mergers among large law firms, creating national (and increasingly international) behemoths. Many firms cite client demand and the necessity of achieving a “national platform” and “credible mass” to justify this trend. But could the fear of losing clients to the competition be as big a driving force behind these mergers as the lure of new business opportunities?

The last two decades have witnessed many changes in the operating environments of law firms that have led to a more competitive market for legal services. The scope of clients’ business activities has expanded, with transactions becoming larger and more complex, often cross-border in nature, and increasingly time-sensitive. Industries have consolidated, and some important clients have disappeared. The relationship between law firms and clients with sophisticated in-house legal departments has become more complex and less certain, as epitomized by the “beauty contest” to win new assignments. There is also increased availability of market information on law firms, including partner compensation.
Many law firms and their attorneys have responded in dramatic fashion to these changes in clients’ businesses and expectations with significant changes of their own. There is a new emphasis on profitability and productivity, increased lawyer mobility which emphasizes the importance of "portable business," tying compensation to productivity, with a corresponding growth in “non-equity” partners and the concentration of internal power in a more “corporatized” form of firm management. These changes have led to the oft-heard criticism that the practice of law has transformed from a “profession” to a “business.”

One of the biggest changes, of course, is the continuing rapid growth of law firms. While throughout the 1980s, any law firm with more than 200 lawyers was considered a “large” firm, today 19 U.S. law firms have more than 1,000 attorneys and the 100th largest firm boasts 400 lawyers. In 1985, five U.S. law firms had revenue exceeding $100 million. Today it is exactly five firms which have revenue over $1 billion.

But the most striking change in law firms is the continuing trend of rapid growth over the past decade by means of mergers. Whereas 30 years ago a New York firm might open a west coast office to service the needs of a particular client, today firms, often with the assistance of a law firm consultant, consciously adopt expansionist strategies unrelated to existing clients or known law firms. A firm will often decide the desirable characteristics in a merger partner, go down the list of firm rankings to identify likely candidates and approach a number of different firms before achieving a merger.

Why This Merger Phenomenon?

Although rapid law firm growth has been with us since the 1980s, the acceleration of this trend by means of mergers is puzzling. Mergers involve significant risk. They are hard to accomplish, often due to issues of client conflicts and partner compensation, and the post-merger integration of firms faces similar obstacles. They are highly disruptive, and lawyers may leave the firm. The literature on corporate mergers suggests they are often unsuccessful in adding value for shareholders, and law firm mergers involve no significant economies of scale. As in corporate mergers, a true merger of equals among law firms is rare; typically one of the firms is acquired and disappears. In addition, lawyers and large law firms generally tend to be risk-averse compared with corporate managers. Why would normally conservative law firms embark on a merger strategy which appears to encompass significant risk and uncertain benefits?

The explanations offered for the merger phenomenon are plausible, but may not tell the whole story. The law firms themselves cite client demand for specialized knowledge, geographical reach and the ability to assemble large teams of lawyers on short notice — i.e., “one-stop shopping.” However, there is no real data to back up this presumption of client demand, and one can find both large corporations and law firm consultants who claim it is unfounded. In fact, compared to other “businesses,” law firms devote relatively little systematic effort to finding out what clients want. Another explanation involves comparing law firms to accounting firms, with the implication of an “inevitable” industry consolidation. However, law is local and there is no compelling need, as in accounting, to utilize similar principles and treatment throughout the national and international operations of a single business organization.

If much of the change at law firms is a result of increased competition in the market for legal services, asking some questions about the nature of such competition may also provide clues to a more complete explanation of law firm mergers: For what do law firms compete? How? With whom? Firms obviously compete for client business, but that includes not only retaining and expanding business from existing clients, but also competing for business with new clients. Law firms are also simultaneously competing for quality attorneys, both new associates (i.e., law school students) and lateral partners and associates.

Increased Competition Through Reputation

The key factor is how firms compete: through reputation. Many businesses compete on the basis of price, but that is not the primary consideration for large corporate law firms. Rather, both firms and clients would say that their main concern is a firm’s work quality (followed by responsiveness and cost). But “quality” is difficult to measure in any case, and many of the important constituencies of a law firm have no direct contact with either a firm or its attorneys. How can they judge a firm’s quality? The same way we judge most service providers (including law schools!) — by their reputations for quality.

Increasingly competitive conditions in the market for legal services have "raised
the stakes” for firms, rewarding those who adapt and punishing those who do not. “Punishment” may include acquisition by another firm, or, in a number of recent, well-publicized examples, even the breakup of well-established firms. Given the higher stakes and fast-moving market, firms have become desperate to find ways to send signals of their credibility and reputation to their core constituencies — clients and potential clients, other law firms (potential laterals) and law students (potential associates). The most effective way to send these “reputational signals” is, in fact, to emphasize successes with one of these constituencies — obtaining a prestigious new client, new laterals or new associates from prestigious law schools.

It is also obvious with whom law firms are competing; other law firms. This leads to the importance of reputation signaling being reinforced by “herd behavior.” If it is difficult for clients to judge law firm quality, it is also difficult for law firms to be confident of what clients truly want. Under such circumstances of uncertainty and incomplete information, it is unsurprising that law firms are strongly influenced by the actions of other firms. This is particularly true for mergers, which result in dramatic attention-grabbing headlines and the promise of a “larger platform,” which is intended to increase a firm’s ability to retain and attract desirable clients, lateral attorneys and new associates.

It is also useful to ask more specifically which large law firms engage in mergers. There is a group of the most prominent Wall Street firms, sometimes dubbed “first-tier” firms by law firm consultants, who do not engage in mergers. These firms seek to maintain their highly profitable niches at the upper end of the market (focusing on “high value-added” services such as M&A, capital markets and significant commercial litigation, i.e., the “bet the firm” deals which are not price sensitive) and do not pursue a strategy of rapid growth with numerous offices and areas of expertise. Their strategy appears to be successful. A comparison of firm reputation (by surveys such as the Vault 100) and the various law firm rankings in the American Lawyer and other publications indicates that firm reputation correlates closely with profitability, not with size.

It is the other large corporate law firms that are likely to compete through the pursuit of growth, both in terms of geographic area and areas of expertise, and to pursue mergers. This may be a plausible business strategy — an attempt to capture the wide “middle” of the market in the hope of maintaining their client relationships and volume of work, while at the same time eventually increasing their proportion of profitable, high value-added services at the top of the market (think of Toyota’s strategy for penetrating the American car market). But it is also an attempt to compete with the first-tier firms (and each other) in terms of reputation and ability to appeal to core constituencies.

The Big Mergers of 2005

According to a Jan. 31, 2006, article in The National Law Journal, the biggest law firm merger in 2005 was Piper Rudnick’s combination with London-based DLA and with Gray Cary Ware & Freidenrich to create a 3,000-attorney firm. The second-largest merger was between Pillsbury Winthrop and Shaw Pittman, a deal that formed a 900-lawyer outfit.

Other large couplings included:

- Kirkpatrick & Lockhart with London’s Nicholson Graham & Jones, resulting in a 1,012-lawyer firm.
- Edwards & Angell, in Boston, with Palmer & Dodge, also in Boston, which formed a 520-attorney firm.
- Squire, Sanders & Dempsey with Steel Hector & Davis, resulting in an 804-attorney firm.
- Ropes & Gray, in Boston, with New York’s Fish & Neave, creating a 716-attorney firm.

An International Comparison

How about other countries? Are law firm mergers a peculiar American (or Anglo-American) phenomenon driven by a large number of lawyers and aggressive management of law firms as big businesses? In an international comparison of law firm mergers in selected developed countries, I found a similar merger trend in all countries studied. In federal systems like Germany and Australia, regional firms combined in the 1990s to form national firms (to give
one example, the Australian equivalent of a New York-Los Angeles merger is a Sydney-Melbourne combination), creating two-tier systems between national and regional firms. Even in Japan, a unitary system with a small firm presence in the relevant market. As in the United States, I suspect that the law firm explanations tell only part of the story. As large corporations everywhere have increasingly become multinational enterprises, there has been a corresponding increase in fluidity and competition in markets for legal services. Law firms everywhere are seeking to adapt successfully to these new conditions. In doing so, they try to compete in terms of credibility and reputation to improve their chances of obtaining desirable clients and attorneys. In the absence of complete information, many firms will accept what has become the conventional wisdom on the need for “credible mass” and “one-stop shopping” in the hope of qualifying for the short lists of important clients.

### Is There Any End in Sight?

The current conventional wisdom is that a “major” law firm with significant clients now needs a national (or, increasingly, an international) “platform” and “credible mass” (with the law firm size required to achieve this nebulous goal increasing very rapidly over the last decade). Given uncertainty and incomplete information, it may well appear to law firms to be “risky” to stand pat and face the possibility of losing existing clients to more aggressive competitors who capture headlines through substantial mergers. If this is even partially true, mergers are not the result of any clear view as to what is the most “efficient” or “best” size for a law firm. Rather, an aversion to being perceived as “falling behind” the competition may continue to act as a spur to law firm mergers.

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