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Getting profit-sharing arrangements right in a merger

A merger makes sense if the new firm is better able to compete than either of its antecedents. For some firms, 'compete' means that the merged entity simply has a better prognosis for long-term survival, while for others it will be characterised by more opportunities, an improved market position and a reshaped business model.

Regardless of the strategic rationale, implicit in any notion of being "better able to compete" is an understanding that sustainable shareholder returns will improve, if not instantly, then certainly in the short term. In a conventional law firm model, with profits fully distributed each year, what this means in practice is that average profits per equity partner will be better post-merger than pre-merger.

How these profits are generated is central to strategy development and, thereafter, the effective implementation of the business plan. How they are shared is a matter for the partners to decide and then engross in the partnership deed or members' agreement. The two are joined by any mechanism that links strategy, realisation of business plan objectives and personal performance. The alignment of partner behaviours and performance with the achievement of wider business objectives, in both the short and longer term, is key.

There are a number of challenging conversations to be had in any merger negotiation when the issue of profit sharing is debated. Such discussions and proposals have the potential to derail, divert or even become deal breakers. To avoid this, any system must be developed with high levels of partner engagement, objectivity, transparency and fairness.

Two issues need to be considered:

1. the number of full equity partners in the new firm; and
2. the way in which these partners should share the profits generated.

Equity partner numbers

A core issue is how many of the equity partners of the antecedent firms will be full profit-sharing members of the new one.

An approximation of the new firm's maximum partner numbers can be achieved by considering the sustainable profit pool that will be generated and dividing this by an acceptable average level of profits per equity partner (PEP).

The result of this calculation indicates the total partner numbers that can be accommodated without dilution below the average acceptable PEP. Comparing this number to the aggregate number of existing partners points towards the level of reduction in partner numbers that may be required.

This is a blunt instrument but is used (perhaps dressed up in more glamorous language) by many firms when looking at their economic model. Also, to be clear, this indicates the maximum number of full equity partners, which is not necessarily the same as the most appropriate or desirable one.

> **"Profit-sharing proposals can become deal breakers in merger negotiations"**

In some cases, a view will be taken that a reduction in total numbers will be necessary. The starting point should not be to assume that all current equity partners wish to participate on the same basis (or even at all). There may be a cohort which, for reasons of career stage or a desire to de-risk their personal positions, does not wish to transition on a like-for-like basis.

Furthermore, such calculations of equity partner numbers often assume that historic profit-sharing arrangements will continue. Changes here can have a significant impact on acceptable partner numbers, financial distribution and personal performance.

Profit-sharing arrangements

A further core issue, therefore, is how the new firm shares profits going forward. The spectrum of solutions available range from a traditional lockstep through a modified variant (walking the line between the traditionalists aiming to preserve the status quo and the modernisers pushing the envelope) all the way through to a full merit-based system (probably employing some form of weighted balanced scorecard employing both leading and lagging indicators).

Arriving at a model which is acceptable, gives reasonable future-proofing, allows for the recognition of 'super performance' and which is workable in practice holds the key to success.

A final challenge is to decide on the mechanism employed to make the initial profit-share calibration. Transitional arrangements (required for a period in order to bring historic profit-sharing systems into a single approach) are useful in also allowing for phased calibration and adjustment.

There is an opportunity to finesse proposals, perhaps by running a 'shadow year' in which, for illustrative purposes only, partner performance over that period is applied to the new profit-sharing model. This demonstrates the approach in practice and gives individual partners an indication of how their current levels of performance would be rewarded in future years.

For modern firms and progressive partners, the notion of a rigid lockstep is antithetical. A merger provides an opportunity to modify, or change completely, profit-sharing arrangements. While the effects of such changes may not be welcomed by everyone, it is vital that all partners understand the process and accept that it delivers an equitable outcome. mp

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