Five Tips for Law Firms in Transition

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Law firms are like many other businesses and often go through major transitions; be they mergers or spinoffs. When transitioning a firm, managers need to consider internal controls, tax and debt obligations, the practice's value, and the cultural fit of a merger. Under all circumstances, emotions play a key part and must be kept in check. This article presents tips to handle all of these concerns.

TIP NUMBER ONE: Pay Extra Attention to Internal Controls

In times of transition it is extremely important to pay extra attention to internal controls. Some law firms may believe that a tragedy could never happen to them. However, the bankruptcy and subsequent liquidation of Hannoch Weisman and the recent bankruptcy filing of Zucker Goldberg Ackerman shows that even firms with great reputations and decades of success can rapidly enter into a crisis.

For some firms going through financial hardship, the accounting department may be significantly reduced and many of the important controls not monitored. In one instance, we came upon a firm who had not replaced its departed controller. The bookkeeper assumed additional responsibilities which allowed her to review payables, sign checks, and reconcile the bank accounts with no oversight. It was discovered that many of the checks she signed were paid to herself or relatives and buried in the company's records. The firm's partners suffered a loss of approximately $75,000, most of which was never repaid.

Another example of the danger of having insufficient internal accounting personnel includes such a circumstance that resulted in the firm's payroll and payroll taxes being all but completely left to the outside payroll service with no internal review. The firm did not have its payroll taxes impounded by the payroll service. The internal accountant paid many important bills and did not have the funds available to make the tax payments. The firm survived only because several of its partners had personal liability and loaned funds to the firm to satisfy the problem.

TIP NUMBER TWO: Understand Tax Consequences and Debt Obligations

Be aware, there may be unintended tax consequences associated with the transition. It is imperative that you determine the tax nuances accompanying your entity's change. In the case of a merger, securing an understanding of each firm's tax compliance reporting methodologies such as: case cost reporting—hard vs. soft costs; sales and use tax filings; multi-state filings; disclosure of non-deductible expenses; and other tax compliance matters is essential.

Similarly, be sure to have a full understanding of existing debt obligations including: credit lines or notes payable, including their maturity dates and financial covenants; and office and equipment operating and capital lease obligations and their accompanying maturity dates.

TIP NUMBER THREE: Know the Value of Your Practice

In the case of a merger or sale, no matter what the buyer pays, he will want to have an orderly transition, need to know who is staying, who is leaving and what that means to the practice profitability and future marketing efforts. The value paid to the departing partners will affect the value of what is left for the staying partners. Recent data show in over 60% of U.S. law firms, partners aged 60 or older control at least 25% of total firm revenue. One third of those firms have a formal succession planning process. With all this in play, *it is essential to know the current value of your practice*.

Law firms cannot have non-compete agreements with attorney partners and employees. It is for the client to decide whether to go with the new buyer or the departing seller. Hence, measuring

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the "who gets what" is often litigated. Once all is settled, the remaining partners go through a merger transition.

Firms/departing partners have been sold for multiple of earnings, multiple of revenue, and multiple of compensation paid to the departing attorney. The purchase price is sometimes broken into net assets and the balance over time. The actual multiplier is based on a long list of items including quality of the client base, source of clients and referral sources, the nature of relationships (institutional or transactional) and ability of remaining lawyers to perpetuate the business, among others.

TIP NUMBER FOUR: If the Transition is a Merger, Make Sure Both Firms are a Fit in the Way They Do Business and Determine Value

It is of enormous import to be sure the acquired firm's way of doing business fits with that of the acquirer. For example, if a small firm merges into a larger firm, at year end the small firm may agree to pay out the excess profits in various ways, including some level of subjective scoring. The new firm may pay compensation solely based on productivity, marketing, ownership, or a combination of each, and ignore the sweat equity from the small firm.

Initial equity (the price paid to the firm merging in) may be an agreed upon amount/percentage value. How does that change for growth in younger partners and the payment to the retiring partners as they phase out?

Starting compensation may be guaranteed for a period of time or be free floating. It is wise to run "what if" scenarios to determine the range of outcomes for all parties.

It is entirely possible that as you settle into your larger newly merged entity, partners may find themselves further away from decision making authority and may become owners who are subject to the rules of employees such as reporting, timesheets, and formalized client acceptance approval process.

Likewise, compensation may also be affected. Some attorneys are compensated on what's called "Batty" and "Watty." Batty is "billing attorney:" "Watty" is "working attorney." Each receives a different amount of compensation. Be sure new case classification is attributed to its originator. Politics should not run interference because of the merger.

TIP NUMBER FIVE: Keep Your Emotions in Check

Transitions can evoke emotion especially when a firm is dividing. Those who are able to navigate the waters of transition with the least display of emotion and public outbursts, will generally have more successful outcomes. Those involved in these situations often refer to them as "law firm divorces" because they actually encompass many of the same challenges and thus provoke the same emotions as matrimonial cases.

As a law firm administrator, let your partners vent to you, and not at the professionals engaged to assist the firm through this process. This will reduce the amount of time spent bickering about items of immaterial value and keep to a minimum, the cost of other counsel, experts, mediators, court reporters and others. Help narrow the areas of disagreement beforehand to minimize these areas. Suggest that areas of unresolved, substantive conflict be reserved for outside professionals.

If your firm is in the midst of merger discussions, one of the likely motivating factors is reducing "redundancies" or eliminating areas of overlap. It is probable that both sets of administrative teams will not be needed going forward. Keep your networks current and develop long term relationships with your peers so you remain well connected. Be proactive, as the pace of mergers and spinoffs is likely to accelerate in this shifting environment.

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