BEFORE THE MERGER – DUE DILIGENCE

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I approach mergers like any other project. I use an organized methodology and checklist to help ensure nothing is overlooked in the process. And it is a process, folks, not an event. It is something to be approached with care and caution. I have witnessed too many mergers over the years which have evaporated before the ink was dry on the new letterhead. In most instances I'd shrug and think to myself that anyone could have seen it was never going to work. Well, except for those involved, of course. I've seen mergers which remain in effect, but one or two years later there are none of the attorneys of the merged-in firm remaining. Isn't this usually the way it goes? Well it doesn't have to be.

I've previously written about the fact that there are right reasons and wrong reasons to merge. [See *Merger Mania* originally published in the 10/8/01 issue of the PA Bar News.] I will therefore assume that you have already done some soul-searching to determine that the reasons for wanting to merge are valid. So now what? Well, 80% of attempted mergers don't come about. Mostly that's because firms don't go about the process properly. But fortunately it's sometimes because when the process is handled correctly, impossible obstacles are uncovered *before* the merger; not after, and one or both firms wisely withdraw from the process.

First a word of caution. As you make the preliminary steps to explore the feasibility of a merger, the utmost confidentiality should apply to the process. During the first part of the process —what I refer to as the due diligence phase — or the second part of the process — what I refer to as the compatibility assessment — there is a high likelihood that information will be revealed which will terminate the process. Under public scrutiny, one or both firms can be viewed as "damaged goods" if the merger fails to proceed. Outsiders will speculate and often make false assumptions about what was uncovered about one or the other firm which ultimately made them an unacceptable merger candidate. So you must really stress to involved partners how important it is that this exploration be strictly confidential.

The first step in the process involves performance of due diligence. If you don't get through this process relatively unscathed, there is no point in proceeding further, because you have virtually no likelihood of success. This article will focus on some of the most important aspects of due diligence. In its most basic terms, merger due diligence is about enabling both firms to really know what they're getting or becoming part of. It's about avoiding misperceptions and misconceptions, bait and switch tactics, or creating problems for a firm where there were none before.

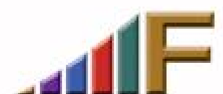
Let's begin first, however, with a moment of candor. Realistically, in most merger instances one firm is being absorbed or acquired by another, larger or stronger—e.g. more profitable—firm. When that happens, the smaller or weaker firm is often reticent to perform its own due diligence, and defers to the information requests of the larger, acquiring firm. That's a mistake. It is important for *both* firms to clearly know what they're getting into. Ok, that being said, let's take a look at some of the most important aspects of due diligence.

1. CONFLICTS OF INTEREST must be explored. It is unusual if there are none uncovered here and there. But in most cases they can be dealt with by obtaining waivers, or resigning in a professional manner which does not prejudice the client. What you need to determine is whether there are any major clients or prospects who will be conflicted out as a result of the merger, and whether there are in fact any conflicting practice areas.

   For example, a thriving insurance defense practice would suffer immeasurably by merging with a firm which did any significant amount of PI work. Even if there were not direct conflicts, the chances are that many of the insurance defense clients would not want to be represented by the firm any longer, due to the perceived positional conflict.

2. VULNERABLE CLIENTS should be revealed. An analysis of each firm's client roster should be made to determine where each firm's vulnerable clients are, and what impact on the firm's profitability the loss of the client(s) would make. Failure to disclose this is like selling a car and failing to disclose it was parked in a lake for a month. It can take some time and thought to do this. But from a marketing perspective, you should be doing it on a regular basis anyway.

   For example, if one of the firms does a significant amount of business law and a major client is thinking of merging into an entity whose GC works primarily with a different firm in another city, this vulnerability should be disclosed up



front. If you are not comfortable disclosing specifics about the client, even with a mutual confidentiality agreement in place with the merger candidate, then you should disclose it in terms of dollars "at risk".

Once this disclosure is made, the potential attractiveness of each candidate to the other under the "worst case" scenario must be considered. If there is truly synergy as a result of the merger, chances are the vulnerabilities won't blow the deal. But if one firm is seeking a financial savior, knowing that the other firm may in fact be in a significantly different financial condition itself if certain events unfold may just change their decision. Better to find out beforehand.

3. What are the PERCEPTIONS OF KEY CLIENTS of each firm about the prospect of the merged firm? Prepare your "elevator speech" about the merger candidate and what you believe will be the benefits for clients. And then meet with a few in confidence to see how they react. Do they see it having positive or negative impact on their relationship with the firm? No matter how positive your firms view the merger, it counts for nothing if your clients view it otherwise.

   For example, if one of the firms is a boutique, their clients may be drawn to them because they perceive that they will get more immediate and personal attention. Clients may believe that if the firm becomes part of a large firm it will result in a decline in service, and a degrading of the perceived importance of their work. It may just drive them away. So unless the merger simultaneously opens the door to bigger and better clients, you might wind up merging your firm out of its client roster.

   As another example, in the course of this aspect of due diligence one firm uncovered bad feelings toward the merger candidate on the part of a key client. It turns out that the client had past experience with a few lawyers who subsequently became part of the merger candidate's firm. The client had such ill will that he stated that he would "never do business with [the firm] again if you become part of that firm." And of course, we know that the result would not be the resulting loss of just the one client. It would be that client, some other clients the client spoke to about the past experience with particular lawyers, and future prospects who would then be referred elsewhere by the lost client, instead of to your firm.

4. What are the BILLING METHODS of each firm? There are a number of variables here to consider. Just one of those is a need to explore on what basis firms bill. Flat fee? Hourly? Contingent? Firms that do some of everything can fit well with firms that bill on any basis or combination. But a merger between a firm which is strictly hourly with another which is contingent-based will often lead to strong conflicts and misunderstandings.

   Typically, contingent-basis firms live in a roller-coaster financial environment. Budgeting is difficult. Cash flow can be feast or famine. Lines of credit are utilized regularly to fund on-going matters. When a big case results in a favorable verdict or settlement, it's a temporarily life-altering event. Payables are cleared, lines are temporarily retired, bonuses are given, capital investments in technology and other areas are quickly spent, and meaty distributions are made. For firms which bill on an hourly or flat-fee basis, this roller coaster is disconcerting, and often produces an unacceptable level of stress.

   Typically, those who bill hourly are particularly disdainful of contingent-fee work when the result is unfavorable and write-offs must occur. They simply don't "get it" that not every case will be a winner. However, if a contingent-basis firm is diligent in the intake process and carefully screens incoming matters for quality, the "hits" will greatly outweigh the "dogs" and the firm will ultimately be profitable. The contrasting perspective from the contingent-basis attorneys is a recognition of the fact that hourly work will only generate excess revenues if production increases per lawyer. And there are only so many hours in a day, and you can only push people so hard. Therefore, a good stream of contingent-fee cases has a greater probability of creating excess value than a good stream of hourly cases.

   Bottom line? Make sure differences in this area don't spell doom post-merger.

5. PROFITABILITY AND OVERHEAD are factors which relate to billing realization, but we're instead exploring the actual overhead cost spent to produce revenues, both including and excluding partner salary.

   There are some attorneys who consistently consume more than $1 in overhead (including salary) to produce $1 in revenue. As a consequence, the more revenue dollars the attorney produces, the worse the financial condition of the firm. So while it may sound impressive that a partner in the firm generates one or even ten million in revenue receipts each year, you would not be happy to find out after the merger that it cost more than that to produce the revenues, because that would result in a reduction in income for yourself and other partners.

Along the same vein, some firms operate more efficiently than others. Overhead may consume just 40 cents of each revenue dollar. By today's standards, that's pretty frugal. But there are firms out there operating at the other extreme with an overhead cost at 60 or more cents of each revenue dollar. So it's important to compare how efficiently each firm is operating.

Don't assume that there will automatically be economy-of-scale efficiencies post-merger which will make one or both firms more profitable. Depending on where the overhead drain is, actual savings may or may not materialize. It is a common mistake to make this erroneous assumption about savings without doing a sufficiently in-depth analysis.

6. BALANCE SHEET items are often ignored. I tend to believe it's because most attorneys just aren't as versed in business accounting, and typically don't understand the significance of balance sheet items. But this is where due diligence exposes debts and other obligations of the firm. There may also be items which need to be disclosed or uncovered because they do not appear on the balance sheet, even as a footnote. For example, the existence of open or pending lawsuits, such as employment discrimination or wrongful discharge, can ultimately result in a huge payout. Unfunded retirement obligations, or buyout obligations for departed partners can come as a nasty surprise post-merger. Even a significant account payable in dispute with a vendor, and therefore not reflected on the books, can become an unpleasant surprise post-merger. If you're from a large firm, you are probably wondering how significant a factor a payable dispute can be. Keep in mind that a lot of mergers happen between relatively small firms, making the significance much greater. But even for a large firm, depending on the vendor and disputed purchase or service, the dollars can still be significant. (Think computer network, telephone system, software, custom animation, litigation support or any of a dozen other items or services which I can think of off the top of my head what can involve very significant amounts.)

7. MALPRACTICE HISTORIES of both firms must be compared, and the possibility of future claims must be examined and disclosed. One firm I know acquired not just a small practice, but an unpleasant surprise in the accompanying cancellation of its professional liability policy post-merger because of the claim history of the acquired practice. This was followed by several malpractice law suits. Every firm's worst nightmare, for sure.

Space precludes me from continuing, and there are certainly more areas which bear careful scrutiny during the pre-merger due diligence phase. Hopefully, this article has raised your awareness that the process may be more involved than you thought. Well, unless of course you want to do what a lot of firms do, which is a) decide that the other firm consists of "good guys" based on having gone to the same college, law school, church, etc, and just do the deal based on a lunch conversation and handshake; or b) decide that the other firm or group won't be around long, contains sufficient "heavy hitters" to benefit your firm, and you'd better move fast and not stop to ask too many questions before the opportunity is lost.

I'm not suggesting that you take forever in this process. In fact, the simple fact is that on average law firms take a lot longer—too long— to complete a merger than any other industry. What I am suggesting is that you be thorough, don't skip important steps, and don't fail to utilize the services of a qualified consultant to assist you if you believe you can't do this properly yourself. Often due diligence is better accomplished by a neutral third party. A separate article will focus on the many factors to explore during the pre-merger compatibility assessment phase.

A version of this article originally appeared in the October 3, 2005 issue of the Pennsylvania Bar News

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