

A Law Firm Merger: What to Expect during Financial Due Diligence

Lawrence R. Chodor, CPA, ABV, CVA



In any industry, Mergers and Acquisitions are driven by a number of strategic objectives: geographical expansion, the addition of a specialty practice area, attainment of critical mass, an advantageous lease arrangement or even an exit strategy. Regardless of the motive, a key to a successful transaction is the deal team. The financial advisor, typically a certified public accountant or anyone else who has specific industry knowledge, can help to orchestrate a clean and efficient transaction. Once there is a meeting of the minds between the parties, the process that the parties in a transaction go through to verify that representations made by each entity are materially accurate is known as due diligence. This process includes financial, legal and operational due diligence. Mergers and acquisitions among professional service firms require no different scrutiny.

A CPA conducting the financial due diligence in a law firm merger or acquisition will examine similar financial elements to those considered in a typical corporate merger. Since professional service firms usually have numerous owners and employ unique compensation formulas that will likely be affected by a merger, the CPA may need to devote significant time to compensation and ownership interests. Overall, the primary role of a CPA in financial due diligence is to maintain objectivity and keep the process moving toward a swift and successful closing.

By the time financial due diligence begins in earnest, a deal has usually been negotiated. That is not to say, however, that all points have been resolved, especially those that may be more sensitive or uncomfortable. Any accounting firm worth its salt will not only examine and test relevant financial documents, but also, and perhaps more importantly, identify potential risks and red flags which may result in additional points of negotiation. An experienced, competent advisor also acts as a catalyst to a reasonable resolution.

What exactly happens during Financial Due Diligence?

Once a preliminary agreement is reached, the CPA should be engaged to conduct the financial due diligence. Unlike a financial audit, where the accounting firm will follow a prescribed set of programs and procedures as an independent reviewer, financial due diligence is directed by the entities involved in the merger. Together with the help of the CPA, the parties will agree on the focus of the financial examination. Typically, the procedures will include:

- Assessment of historical performance and current financial status;
- Determination of entity structure and tax implications; and,
- Assessment of future performance.

Historical Performance and Current Financial Status

One of the primary goals of financial due diligence is the objective assessment of the historical performance of each entity. The accountant's job is to "kick the tires" to ensure that the financials are really as presented. This information is a key to establishing what assets and

liabilities each side brings to the merger. The financial books and records, including tax returns, will be reviewed and tested. You can expect:

- A thorough test of accounts receivables to determine percentage collectable;
- Assessment and valuation of all work-in-progress (i.e., unbilled receivables);
- Assessment of Files to determine recurrent value;
- Examination of Files to identify contingent cases, the extent of work performed, and probability of winning;
- Determination of current ownership allocation for each partner;
- Examination of the current and deferred compensation packages for each partner;
- Examination of any outstanding liens or other legal issues that have financial implications;
- Review of contracts, leases and bank agreements currently in effect; and,
- Review of qualified retirement plan obligations.

The result of this process will be a recast balance sheet and normalized income statement for each entity.

Entity Structure and Tax Implications

A merger of equals is a rare occurrence, regardless of how the transaction is presented to the public. More often than not one firm will control the merged entity, and may, along with tax, legal and financial considerations, ultimately dictate the choice of entity type, or identity of the survivor.

In the most direct form of merger between two organizations of the same entity classification, tax rules may result in the acceleration of taxable income to some or all of the participants. For example, partnership with partnership mergers can result in immediate income recognition if the resulting structure shifts liabilities among the partners in the merged entity. In addition, allocations of future income may be effected by partnership regulations where cash basis receivables and payables are contributed.

Mergers between corporate entities are governed by well established tax law, which requires strict compliance with statutory and regulatory definitions regarding participants, continuity of ownership and business enterprise, and type of consideration. A failure to adhere to these laws may result in immediate taxation in whole or in part to one or more of the participants.

Combinations between entities of differing tax classifications most often present the greatest degree of complexity in planning the tax result. If, for example, a merger is contemplated of a corporation and a partnership entity with the partnership as survivor, a great deal of consideration must be given well in advance of the transaction to mitigate the potential corporate level tax upon liquidation of the corporate target and the resulting shareholder level tax. In a similar circumstance, if the corporate entity will be the survivor, acceleration of unrealized income in the partnership entity may result upon contribution of cash basis receivables and similar items without careful advance planning.

During due diligence, the accounting firm will bring in their tax experts to quantify the tax implications of the merger and advise on the best tax minimization strategy for the resulting firm.

Future Performance

Financial projections are designed to illustrate the anticipated performance of the new entity based on certain assumptions that consider several factors: attorney fees, their client base, specialties and commitment to the merger; duplicate administrative departments; compensation and benefits packages; office leases; equipment and software requirements; and loss of revenue from conflicted clients. Projections can be very enlightening, often raising issues not previously discussed or assumed to be non-issues.

Perhaps most significant, projections will illustrate the impact on the personal retirement or exit plans of each partner. This can be a sensitive issue depending on pre-existing deferred compensation formulas as well as the attitude or age of each partner. The job of the accounting firm is to project the future performance of the merged entity and apply the formula to objectively illustrate the short-term and long-term impact it will have on the new entity.

Projections can also illustrate the affect of losing a key client or the departure of a rainmaker. Who will likely stay and who will likely leave – taking their clients with them.

Keys to a painless process

Above all, the goal of the CPA is to allow the merger process to proceed uninterrupted. Typically, financial due diligence takes between 30 and 90 days, depending on the condition of the financial records as well as the commitment of those involved in the merger. Discussions that drag on for months or years yield disastrous results: bad or inaccurate press; nervous clients; jittery and distracted staff; and increased activity from headhunters.

Don't try to conduct due diligence with internal staff. Even in the friendliest of transactions, financial due diligence performed by internal staff is not the most efficient use of time and resources. Unless getting the merger done is a primary focus of the assigned staff, the process will be sidetracked by more immediate matters. As well, sooner or later the negotiations will touch on topics of personal interest to the assigned staff (e.g., salary and benefits), and objectivity and responsiveness will be compromised. Engage an independent accounting firm to help move the process in the right direction. And, if feasible, engage one firm jointly to ensure impartiality and minimize fees.

Use partners, not staff, in negotiations. Sensitive issues will inevitably need to be discussed openly. What will happen to staff filling duplicate roles? Which systems stay and which are obsolete? How do you compensate personnel who may be earning more than the normalized salaries? How will you balance current and future benefits packages (e.g., earned vacation time, length of employment)? Non-owners should not be party to these discussions.

Discuss all possible scenarios, no matter how uncomfortable. How will future compensation be determined? Will the new firm culture value chargeable hours, billings, new business? How will firm administration, niche leadership and "intangibles" be valued? What happens if a partner leaves shortly after the merger? Good projections in each scenario will reveal the effects for all owners and set a starting point for negotiation.

Be flexible in negotiations. In any merger, a variety of personalities and motivations will be involved. There will be young attorneys looking to a merger as a means to implement a growth strategy. There will be older attorneys who don't want to jeopardize their income during their last years in practice, the years upon which their deferred compensation will be based. There will be control issues and egos galore. Enter negotiations understanding that some points will be won, others will not.

Keep your house in order

Merger and acquisition activity among law firms doesn't seem to be ebbing, so chances are high that your firm will be involved in one sooner or later. Prepare for a merger by asking of your own firm the same questions that you would ask of a potential merger or acquisition candidate. To start, clean up your accounts receivable and unbilled work-in-process. Look carefully at your tax returns and bookkeeper's reports. Routinely examine on-going contracts, such as leases, service and consulting agreements. Review your Files for retainer agreements and any debt incurred related to these cases as well as contingent liabilities. Analyze the productivity within your firm – look at hours billed per attorney/paralegal, realization rates, and time written off.

Mergers and acquisitions will remain important growth strategies among professional service firms. The key to a pain-free transaction is often the engagement of good financial, legal and operational advisors.

Lawrence R. Chodor, CPA, ABV, CVA, is a Partner at Wiss & Company, LLP. Mr. Chodor can be reached at 973-994-9400 or lchodor@wiss.com.