LAW FIRM MANAGEMENT

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Signing on the dotted line
Due diligence for law firm mergers

When it's time to let a partner go

Is a dedicated sales team the answer to this economy?

Study digs into changes and challenges for small firms

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Signing on the dotted line

DUE DILIGENCE FOR LAW FIRM MERGERS

Law firm merger activity dropped sharply in the wake of the COVID-19 outbreak, but some struggling firms are reassessing the strategy as a possible life preserver. The pandemic economy makes comprehensive due diligence more important than ever when evaluating potential arrangements, though. Before signing on the dotted line, both sides need assurance that the numbers add up and no problems are bubbling below sight.

FINANCIAL ISSUES

Not surprisingly, the primary emphasis of due diligence is on financial issues. To ferret out risks, work with your M&A advisors to home in on the following:

Financial statements. Start by reviewing the other firm's financial statements going back at least two years. You'll also want to scrutinize its general ledgers, accounts receivables and payables, work-in-progress, notes payable, fixed assets, depreciation schedules, and nonrecurring income and expenses. Gathering this information will help you estimate the value of the other firm's shares or its net assets. You can use this information to determine the price and terms of a transaction.

Projections. The other firm should provide projections on partner buyout costs, impending retirements over the next five to 10 years, client retention and billing rates. If not included, request additional information on the assumptions and data that form the basis for those projections so you can determine whether they're reasonable.

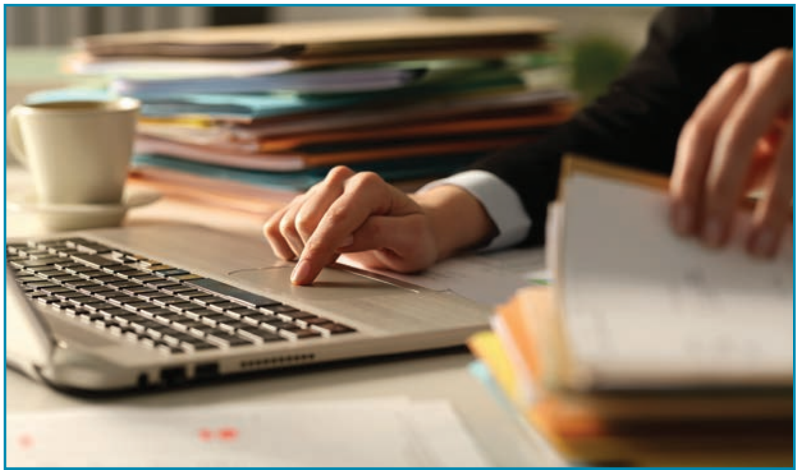
Tax history. Look at several years of federal and state income tax returns. Sales and use taxes and commercial rent tax also warrant examination.

Liabilities. Consider both on- and off-balance sheet items — including outstanding liens, unfunded retirement obligations, unpaid tax liabilities, deferred compensation, pending litigation and other contingent liabilities. Look beyond the facts and figures for potential underlying problems.

Malpractice claims. Any malpractice history should trigger further research. Defense, damage and settlement costs and their effect on insurance premiums are important, but you also want to know about attorneys with a trail of claims.

Billing practices. What payment methods does the firm accept? What are its collections policies and realization rates? Determine if the firm routinely permits clients to drag their feet on paying their invoices or if it gives in and offers discounts, thus rewarding clients for late payments.

Client reliance. How much of the other firm's revenues are attributable to its top 25 clients? Determine if there's any risk of losing clients that represent a significant portion of its revenues and the effects if clients did depart.



WHEN YOU DECIDE TO MOVE AHEAD

Even if merging law firms are satisfied with their due diligence results (see main article), much planning still remains to facilitate a successful merger. Topics to consider and questions to ask include:

Management and governance. What will be the management structure? What role will the board of directors and its committees play? How will you structure and integrate practice groups?

Premises. Which office locations will be closed or combined? How and when?

Technology. How will you align your systems for areas such as accounting and finance, document management, practice management, customer relationship management, and legal research? How will you combine your databases?

Human resources. How will you reconcile different policies for issues such as training, performance management and annual compensation adjustments? Will overlapping positions created by the merger force you to lay off workers and, if so, what kind of severance package will you offer? Will you include restrictions such as noncompete and nonsolicitation agreements?

This is just a sampling of the areas that you should research. To make the transition smooth, tackle them as far in advance as possible.

ENTITY STRUCTURE

The structures of the current firms and the merged firm could lead to unpleasant surprises in partners' tax bills post-merger. The merger agreement will need to address this issue. For example, if both firms are partnerships, some or all of the partners might see accelerated taxable income on their individual tax returns due to the pass-through nature of a partnership.

If a partnership merges with a firm that's a professional corporation taxed at the entity level to form a new partnership, the corporation would liquidate. If this is your situation, consult your financial advisor to determine the tax implications of corporate liquidation. Be sure to include all such potential effects in the financial modeling performed to estimate the new firm's profitability.

ATTORNEYS AND STAFF

The acquisition of reputable, quality attorneys generally is one of the goals of law firm mergers, so you need to know what the firm's partners and associates bring to the table — both good and bad. Who are the rainmakers and who might leave soon? Are incentives advisable to retain them and, in turn, their clients? Which practice areas are the strongest and weakest? How does compensation break down? What do the demographics look like?

Too often, firms pay attention only to a few key people in the other firm. The better approach is to look at everyone, including nonattorney staff. For the latter, determine their titles, responsibilities and salary histories. And, for both attorneys and nonattorneys, it's a good idea to run background checks.

CULTURE MATTERS

Finally, don't let the focus on numbers and similar data distract you from assessing cultural compatibility. Without alignment in values, overall goals and a sense of social responsibility, a deal that looks like a no-brainer on paper can end in failure. •

When it's time to let a partner go

Partners can go through waves of being productive and not-so-productive. But what should a firm do about those partners who can't seem to get out of a rut — or even worse, don't seem to want to? While it's not the type of situation any managing partner wants to deal with, tackling the issue head on is the best course of action.

HOW DO YOU DEFINE PERFORMANCE?

The definition of underperformance depends, in large part, on your firm's written and unwritten expectations, its criteria for evaluating performance, and the terms of your partnership agreement. Increasingly, in some firms older partners are being labeled as underperformers not because their contributions have changed, but because their firms and the legal marketplace have raised their standards.

To prove underperformance, your firm first needs to define it. In general, underperforming partners:

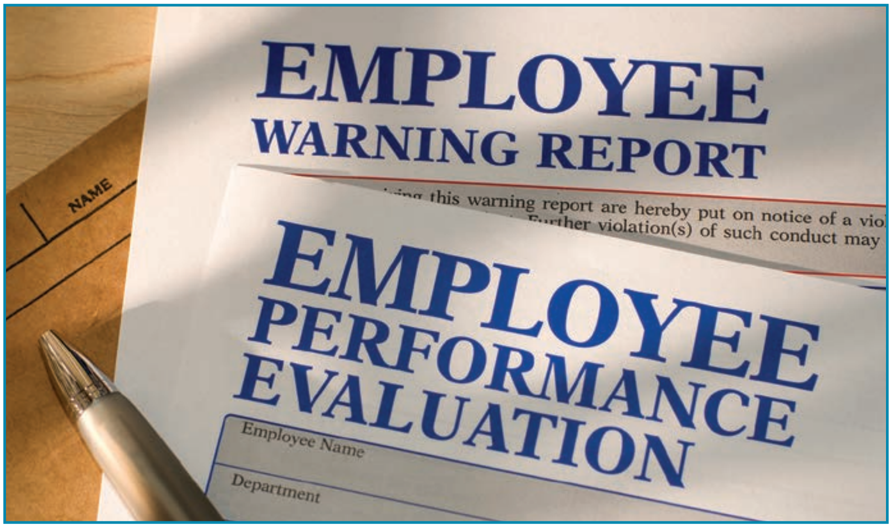
- Regularly bill fewer hours than their peers,
- Fail to develop a self-sustaining practice, which includes introducing new clients and engagements to the firm,
- Are unable to manage engagements and projects profitably or to the client's satisfaction, and
- Can't (or won't) adapt to a more competitive and demanding legal marketplace, to your firm's changing values and objectives, or even to new technologies.

Most underperformers show signs of burnout, exhaustion, anxiety or boredom. Note that unethical behavior or misconduct generally aren't considered performance issues. You should address such situations separately.

WHAT'S THE COST?

It's common for firms to ignore struggling partners, hoping they'll find their own way back to productivity — or leave the firm. Neither scenario is likely. Most underperformers know they have a problem but don't know how to fix it. And few people willingly leave a secure job, even one that offers increasingly diminished returns.

In the meantime, underperformers cost your firm in the form of lost work, weakened client confidence and lower staff morale. The partner may even stand in the way of a deserving associate's promotion, recruitment opportunities or a successful merger with another firm.



Try to quantify these costs and present them, as well as other "objective" evidence such as average profit per partner, to the underperforming attorney during his or her compensation review or in a more casual one-on-one meeting. Don't blame or accuse the partner, but instead express concern and ask how you and other partners can help get him or her back on track.

CAN CHANGES BE MADE?

If you believe rehabilitation is possible and the underperforming partner is willing to accept help, develop a performance management plan. Start by setting specific and measurable objectives, such as increasing billable hours by a set percentage or engaging a specific number of new clients in the next year. Then provide the partner with the support he or she needs to achieve them.

Support can include mentoring by your firm's top rainmaker, continuing legal education, or networking, financial management or computer courses. Consider a personal organization or career coach, or if the primary issue is burnout, a vacation or short sabbatical. Meet regularly with the partner to assess progress and discuss possible obstacles. Try to be flexible and patient as you work with an underperforming partner.

WHEN IS IT TIME TO LEAVE?

It's important to know when to cut your losses. Not every underperforming partner is capable of — or interested in — making needed changes. If the partner exhibits little progress or commitment to change after a predetermined period (a year is typical), it's probably time to ask that person to leave. In such situations, make sure the partner's exit is handled sensitively.

Passive techniques, such as reducing partners' shares until they're forced to quit, can be as detrimental as aggressive ones, such as giving partners the boot on short notice. Both can damage firm morale and your reputation with clients and prospective hires. Also, unless partners are guilty of misconduct, you owe formerly trusted colleagues courtesy and respect.

Most underperforming partners show signs of burnout, exhaustion, anxiety or boredom.

WHAT'S NEXT?

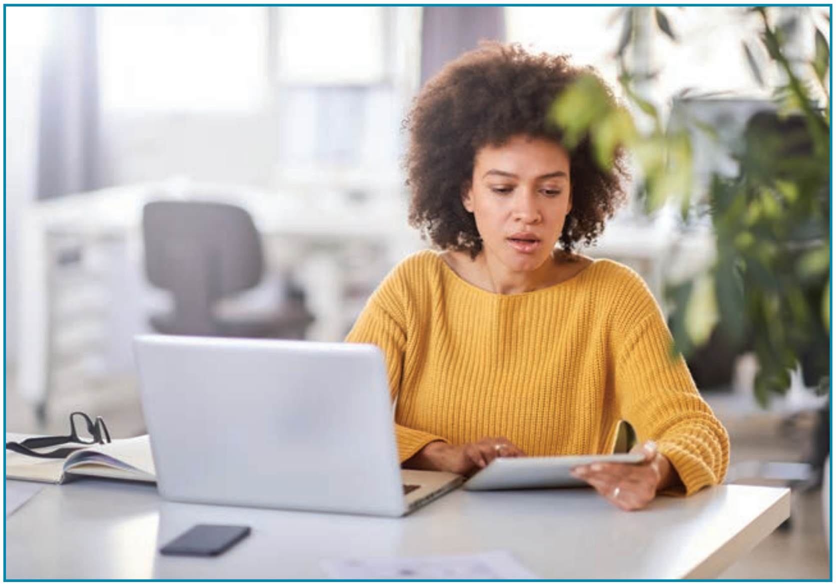
Asking a colleague to leave is a tough decision, but it's in your firm's best interest to move forward with productive partners. Taking action sooner rather than later will result in less damage to your firm's profitability and relationships. •

Is a dedicated sales team the answer to this economy?

The practice of law is almost always stressful, but current conditions make this period and the near future more anxiety-producing than ever. Firms are balancing the COVID-19 pandemic, economic uncertainty and ongoing pressure to bring in new business. This has led some to follow the lead of other professional services and create dedicated teams of sales professionals to help lighten the load. Should you join their ranks?

PITCHING SALES TEAMS

The old guards at some firms have long resisted the idea of using nonattorney salespeople to generate business. But even those who have traditionally opposed the notion may welcome shifting the burden when they realize their firm can enjoy greater revenues while attorneys focus on core competencies. Reducing the expectations for business development lets attorneys



be evaluated primarily on their legal performance and contributions — the reasons they entered the profession in the first place.

Sales professionals know how to make attorneys look good, too. For example, they can coach attorneys and work with them on preparing for and making pitches. But they can — and should — do much more. While attorneys drive the substantive conversation in pitch meetings, the sales pro can drive the sales process and ensure that the deal is formally closed.

Moreover, clients generally appreciate having someone who can quickly put them in touch with the right attorney when new matters arise so they get the best person for their particular projects, rather than the attorney who's the best at marketing him- or herself. Sales professionals often know the firm and its breadth of services better than individual attorneys used to working within their practice areas. They're armed to do the cross-selling many attorneys feel uncomfortable pursuing.

Bear in mind, though, that these perks don't come cheap. Qualified sales professionals typically are paid a base salary, plus a bonus based on revenue. You should expect to pay six figures, and, depending on the size and structure of your firm, a sales pro could make as much as some partners.

HIRING THE RIGHT PEOPLE

Look for someone who has previously met revenue expectations and has experience and contacts in the target markets. You also need someone collaborative, who can work with attorneys as well as marketing, finance and client relations staffs.

Once you hire someone, you must institute an appropriate reporting hierarchy. Sales professionals shouldn't report to the head of marketing: Marketing supports sales. A sales pro will interact extensively with partners and clients and should report to the managing partner or another high-level partner.

Sales professionals often know the firm and its breadth of services better than individual attorneys used to working within their practice areas.

Finally, be patient. No matter how talented, sales pros need time to develop the necessary understanding of your firm and its clients and transfer or develop relationships in the market. It can take six months to a year for the sales professional to get fully up to speed and for you to see a marked improvement in quarterly sales reports. The payoff, however, can prove more than worth it.

LAYING THE FOUNDATION

If your firm opts to bring on a sales professional, you should anticipate objections from some of your attorneys. It's critical, then, that those on the top make the case to the entire firm and clearly demonstrate their support for the endeavor — before the person comes on board. •

Study digs into changes and challenges for small firms

Few areas of life are going unaffected by the COVID-19 pandemic and its economic fallout. But according to research from Thomson Reuters, one thing has remained nearly constant: the challenges confronting small law firms and firms' response, or lack thereof. Although these top-line findings may seem discouraging, the *2020 Report on the State of U.S. Small Law Firms* (the fourth such report), also emphasizes opportunities available for proactive firms.

CONSISTENT CHALLENGES

The study notes that the significant challenges facing small firms have changed little in recent years. The most frequently cited challenge reported by the survey's 400 respondents (all firms with fewer than 30 attorneys) was acquiring new client business. That was followed by spending too much time on administrative tasks and not enough time practicing law. The average attorney respondents spend at most 60% of their time on the practice of law. The rest goes to managing the firm or recruiting or retaining clients.

Respondents also feel increasing pressure related to collections. This is especially relevant for firms with 10 or fewer attorneys, whose size makes them unlikely to employ staff dedicated to billing and collections. As for the competition, respondents said most of the competition comes from other law firms, rather than do-it-yourself legal websites or alternative legal service providers (ALSPs).

LACK OF ACTION

Despite the recognition of clear challenges, most small firms haven't taken meaningful steps to surmount them. Of all of the problems plaguing these firms, getting paid is the one respondents are most likely to have acted on.

Less than one-third of firms had addressed new client acquisition or the management of administrative tasks. Most respondents haven't boosted their marketing budgets in the past three years and don't plan to increase them going forward. This finding jibes with the results of the *ABA TechReport 2019*, which concluded that small firms aren't taking an "intentional" approach to marketing and instead may engage in "random acts of marketing."

OPPORTUNITIES FOR "FIRST MOVERS"

The Thomson Reuters report describes the current state as an opportunity for so-called "first movers" — that is, the first to offer something new to the market. Those law firms that are willing to take action have plenty of fertile ground to become innovators, whether by developing internal efficiencies, honing their expertise in business development or adopting technologies to streamline their practices. Although the survey was conducted at the onset of the pandemic, its results suggest ways for small firms to improve their odds of survival in both the long and short terms. •

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