

Report to Legal Management

OUR 27TH YEAR

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What Every Partner Should Know about the Costs of Merger



Thomas S. Clay

By Thomas S. Clay

A merger is an investment and should be accretive to a law firm's net income per partner. The costs of a merger or acquisition appear in these areas: transaction, integration and revenue impact. This article will deal with the first two areas. The transactional costs of a merger can and do cause a dilutive situation short and possibly long-term. Experienced merger and acquisition professionals know that transaction costs, in the business community, can range between 6% and 8% of the gross revenues of the organizations. Few law firms are experienced enough to closely estimate these costs and, therefore, most often underestimate them — resulting in a dilution of partner profits.

I hope that the more than two decades of experience I have had dealing with law firm mergers will help lawyers and law firms better understand how to assess the costs (or investment, if you will) of mergers. Merging is difficult and risky in the best of times. Understanding the costs better will help any organization in the decision-making and in guiding the combination once the merger is completed.

The Importance of Pro Forma Income Statements

I have consulted on hundreds of law firm mergers (and acquisitions) and reviewed an equal number of *pro formas* over the years. Ultimately, they were all wrong, as *pro formas* always are. But they must be prepared in

order to answer the question, "How much will this deal cost?"

Unfortunately, too many *pro formas* are simply a "slapped together" set of budgets prepared by two law firms. Little quality thought is given to the *key variables* and the assumptions that will impact changes in those key variables. Key variables are those costs that will (just depends on the degree) make up the overwhelming bulk of the cost of a merger. There are a few simple steps to the development of a good *pro formas* income statement. These include:

- Comments on the variability of the forces that impact each item.
- A clear explanation (the assumptions) of the expected impact of the merger for expense item.
- A separate section which outlines the total expected costs of the deal. I always

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insist on this when reviewing *pro formas* on behalf of clients.

- Use professionals experienced in dealing with mergers to help develop the *pro formas*.

If the *pro formas* are prepared by the law firm, they will almost always have significant errors and you will experience nasty surprises. Qualified experts in some of the key areas such as technology and marketing, must be consulted in order to gain a better picture of expected costs. Simply put, if you haven't been through one of these before, it is nearly impossible to understand the totality of costs.

When Should You Assess Expected Costs?

If the critical Go/No Go phase is conducted properly, then the initial cost assessment should occur *before* (or concurrent with) any further evaluation/due diligence/negotiations. I conduct numerous Go/No Go evaluations each year and insist on the firm's completing a preliminary cost assessment if the combination appears to merit moving forward. Getting a preliminary assessment is beneficial to the entire merger process because the two organizations learn an enormous amount about one another's operations, policies, culture and the like. In addition, the early assessment facilitates the process by identifying issues and problems earlier.

I have observed that firms that wait too long to make the first assessment are often faced with deal euphoria/inertia, which can cloud judgement. The sooner you have an idea of potential costs, the better decisions you will make.

A Word About Economies of Scale

An analysis of the statistics contained in the Altman Weil *Survey of Law Firm Economics* for the past ten years demonstrates that the larger the law firm, the more the overhead per

lawyer. Other surveys confirm this fact. There are no economies of scale of significance in law firm mergers. Yes, accounting staff may be reduced, or a receptionist, or a librarian let go, but the larger IT staff and marketing staffs will offset those savings. But those savings are long-term. In the short run, you are more likely to need the full complement, if not extra hands, to merge the two firms.

Banks and other service industries routinely justify mergers because of expected "efficiencies in operations." This means massive layoffs and consolidation of operations. Law firms do not enjoy such rationalization of assets to any great degree. Accordingly, economies of scale play no great role in mergers. If the merger is touted to be one that will cost you very little because of economies of scale, be very skeptical.

Key Variables

The following, based on my experience, represent those costs which most impact merger transactional costs. **You can be reasonably certain that costs in each of these areas will probably exceed the current costs borne by the two firms independently.**

Salary and Benefits Equalization

Salaries and benefits of staff and associate lawyers make up the overwhelming costs in law firms. Because law firms are labor intensive, fully loaded labor costs are substantial when firms merge.

When firms merge, equalizing salary and benefit levels is the typical procedure. When a "benefits-rich" firm merges with a firm offering marginal benefits, the costs to equalize can be enormous. In addition, staff are sensitive and protective of perquisites. I have seen major morale problems when one firm tried to do away with \$50 per month parking allowances, creating a terrible situation from which the firm ultimately had to retreat.

Always engage experts to help determine what options are available with respect to benefit equalization.

Technology Costs

The fastest growing cost in law firms are technology-related. These are typically the costs that are most underestimated by law firms and result in unwanted surprises.

You must assume that the combined firm will operate with the same technology platform immediately. Not to do so will adversely impact activity integration and acculturation, and that is unacceptable.

It is essential that the firms retain professional help to determine what the technology costs of hardware, software, migration/conversion and training will be. Firms that rely only on internal staff and vendors to determine these costs will almost always be disappointed. Law firms spend \$8,000 to \$12,000 (U.S.) per lawyer, per year, in technology costs. It is easy to see how a significant technology investment will be required to ensure everyone is on the same platform and is trained.

Space

I was recently involved with a large merger in which one firm had just committed to a lease for to-be-built space. The decision to abandon the new space in favor of moving in with the merger partner cost in excess of \$2,000,000.

Space costs are exploding. Firms spend \$15,000 to \$20,000 (U.S.) per lawyer (even more in California) on occupancy costs. The variables in calculating costs are numerous because of the different type of merger, i.e. same city mergers, a need to move offices, etc., and expert assistance is required to properly determine costs.

Finally, the statistics show that larger firms almost always have higher per lawyer occupancy costs than smaller firms.

Malpractice Insurance

These costs can be neutral or

significant depending upon many parameters such as the type of practice, the deductible amount, availability/cost of prior acts or “tail” coverage and the like. Of course the firms’ claims experience will have a large impact on the cost of insurance. Again, only through the use of professionals can an accurate picture be made.

Marketing

Marketing and public relations is the cost (investment) *that can most support* the objectives of the combination. Yet, in my experience, many firms underinvest in this area in an attempt “to save money.”

I was asked a few years ago to evaluate the rationale for a merger in which the parties were most excited about the opportunity to cross-sell one another’s clients (something almost all merger partners hope for). I asked two questions.

1. Will the compensation system encourage the necessary collaboration (behavioral change) to ensure cross-marketing?
2. Do you have a solid process in place to manage a client cross-marketing initiative?

The firms were not even able to comment on the second question. I explained that effective infrastructure to support cross-marketing would include staff, databases, research facilities and the like. The firms had not considered their organizational, structural and support needs in this area and needed to budget for expenditures. At the end of the process, we discovered that staffing, technology needs, space and the like would exceed \$1,000,000 per year, a cost that had not been considered, but was critical to supporting the major reason for the merger.

Activity Integration and Acculturation

Activity integration, getting people to do things with one another,

and acculturation, melding of cultures, are two of the *most important needs* of a combined organization. Other than a few mixers and signing dinners, few firms actually budget for these critical functions.

We know from experience that if organizations are, in fact, to operate as one, people will have to get together and talk — a lot. Practice groups need to meet and leadership needs to be seen in all the offices.

Make sure that you budget for these costs and the associated time and, more importantly, that you have identified the activities necessary to ensure activity integration and acculturation, throughout the firm, not just among the lawyers.

People Moves

Integration and acculturation will occur more successfully when people see one another frequently. In separate city mergers, securing commitments of lawyers to move and work out of new locations is extremely valuable.

Most firms will pay the costs of relocation, essentially “making people whole.” However, if you truly want to entice people to move for the benefit of the organization, you should consider paying moving bonuses. I recently recommended that a firm pay up to \$250,000 to a key partner to entice him to move to the city in which the firm was acquiring an office. I reasoned that this was a little enough investment to help ensure that this major strategic move was successful.

Professional Assistance

Use professionals to help ascertain costs, especially where the professional’s experience outweighs yours. Legal, accounting, benefits, real estate, technology and public relations experts can all play a role. These costs need to be budgeted.

Headhunters and Search Consultants

Many firms use headhunters and search consultants. Some of these fees

can be quite substantial and should be budgeted as part of the transactional costs. Too often this cost is hidden in the firms’ overall professional fees, and it should not be.

Other Costs

There are a myriad of other costs that will occur. Only through diligent line item by line item assessment will you be able to determine what those might be. In addition, it is always rational to have a contingency or fudge factor.

Rule of Thumb

I am often asked for a rule of thumb pertaining to the costs of merger; i.e., an amount per lawyer or a percentage of revenues. Unfortunately, the numerous variables affecting costs make calculation of a useful rule of thumb impossible. However, I can state with certainty that not following the advice herein will result in very nasty surprises. Your objective is not perfection in predicting costs — but just being close enough not to cause serious harm to the new firm.

Summary

Making a merger or acquisition successful is always difficult. Don’t hamstring the combination by underinvesting, either intentionally or because costs weren’t estimated properly. I see too many examples of combinations where costs were underestimated and when it was time to nurture the investment by spending money, it was undernourished, thereby inhibiting post-merger value creation. A merger is an investment opportunity. Like any good investment, you need to know the costs to make sound financial judgments, both pre- and post-merger. ♦

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