

the firm

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Mergers - A force for the future



Karen Hain and Andrew Deakin

IF you are running a law firm in the UK today, then the chances are you are considering at least one merger right now.

The consolidation of the market is now well underway. Firms at all levels of the sector are looking to mergers as a way of addressing strategic issues they are facing.

Andrew Deakin, business development consultant and director of Hope Marketing Services and **Karen Hain**, head of professional practices and partner at Moore and Smalley, look at the issues being faced within the legal market and the impact mergers are having.

Are mergers an important strategic growth option for law firms today or is the rush of mergers being driven by economic uncertainty?

AD. In all reality, it is probably both. For many firms, a merger is a key strategic device they will use to achieve rapid growth. Mergers can achieve many things. They can provide access to new markets through the addition of new geographies. They can enable firms to either add new service offerings or to enhance existing ones through creating more strength and depth. And of course there is scale and critical mass. This

can bring about cost savings as functions or offices are combined, but it can also provide access to new clients or types of work.

So mergers are absolutely a viable option to consider when looking at growth opportunities in a law firm. But some firms do not have a strategy at all, let alone a merger strategy.

If you don't know where you are going, then the good news is that you can never be lost ... but I am not sure this should be of any comfort in an increasingly competitive market.

KH. Of course the impact of the recession cannot be ignored. We have gone through such an extreme economic downturn that many firms have been forced into considering mergers as a means of survival.

We have seen multiple mergers where a number of smaller firms have got together. The obvious benefit is the immediate cost savings to be gained by extracting duplicated overhead costs.

There have been some mergers necessitated by such high professional indemnity insurance premiums that the only other alternative was to close the front door and pay the run-off insurance.

The tough economic conditions have brought to the forefront financial concerns. But strangely this negative has generated real positive plans for growth that may never have reached the discussion table at all if it were not for the dire financial forecasts.

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Mergers - a force for the future continued

What do you think is driving the continued high levels of merger activity in the UK?

AD. Growth remains a key driving force behind the merger activity. Firms know that to expand into a new geography is very difficult and to open a greenfield operation is generally considered to be a poor investment decision. It simply takes too long to build a following from scratch in a new territory, so firms are forced to consider either a merger or taking on a significant lateral hire.

KH. I agree that growth is a key factor. But firms are becoming much more open to discussing mergers. I don't want to suggest that it is "fashionable" but certainly forward thinking modern law firms are not so quick to dismiss the suggestion these days.

There is an increasing pressure on practices to keep finances as strong as possible. But under extreme economic factors, financial results have suffered. Firms are therefore looking at how to spread the risk attached to running the business. This is one of the reasons that we are seeing more mergers as firms are managing risk profiles.

What impact do you think the likes of Co-op Legal are having?

AD. Well we can expect to see certain types of commoditised work migrating away from traditional law firms. Residential conveyancing, wills, probate, personal injury and even certain aspects of employment law are already available through retail operations such as the Co-Op or the RAC. Firms still operating in these markets are going to have to face up to the reality that over time, their market share of these types of work will simply erode. But that doesn't mean that clients are going to be taking their complex legal issues away from law firms any time soon. Provided firms get the mix of work types right, they should have a secure market to serve for many years to come.

KH. Competition from new entrants into the market will hit those firms which have not planned for change. If firms are planning to compete in commoditised work then they will see an immediate hit to margins. Prices will be cut, and work practices will have to become more efficient with perhaps lower graded fee earners performing the routine work in order to remain profitable. Mergers could generate sufficient economies of scale from which a competitive product could be launched.

What are the most common mistakes that firms make when undertaking a merger?

KH. The key to making a merger work for each partner is to ensure that financial alignment is successful. This aims to move each individual into a comparable earnings model. It is simple to compare profit per equity partner (PEP) and say "mine is bigger than yours". But the

plan must be how much PEP can be earned in the merged business and how profits will be shared in the future. Getting the right accounting policies set out for the merged business and understanding their financial implications should not be ignored.

AD. One problem is that lawyers can tend to over-analyse things. They are looking to eliminate uncertainty, to fully understand every risk and to mitigate for every potential liability. But this just isn't practical for most mergers. You cannot reach a point where you know everything about the firm you are proposing to merge with. You have to focus on the things that matter most and accept that you will learn things about your new colleagues long after the ink has dried on the agreement.

How long should a merger take to complete?

AD. There is no correct answer to that. Mergers of different sizes and shapes will take differing lengths of time to complete. What shouldn't be drawn out unnecessarily however, are the negotiations as to whether the merger should proceed. There is no reason why due diligence and initial discussions should not be completed in 3-4 months. Actually completing the merger with all the integration that can be involved is what can take the time.

KH. Give an accountant a due diligence (DD) exercise and watch their excitement!

In reality a desktop DD could quite quickly be undertaken to identify those high risk or significant value areas requiring further review. If this is done fairly early on in the merger talks then dealbreaker issues can be highlighted before any further work is completed. This can be done alongside the financial alignment plan so that detailed work on the figures can be run together with the DD, and can be relatively quick and painless if the firms opt for full disclosure with a risk based approach to the DD.

Should the firms use a merger as an opportunity to introduce new structures or working practices?

AD. Absolutely. Mergers can be hugely disruptive, but what happens when you enter into one is that your people will be focused on, and prepared for, change. They will be more receptive and more open to new ideas. So whether it is a new management structure, or a change in the organisational set-up, a merger (with the tight timetable it brings) can be the ideal opportunity to drive through significant change.

Mergers of different sizes will take differing lengths of time to complete

KH. With the proposed changes to tax rates for high earners, getting the most tax efficient structure for the merged entity should be on the agenda early on. This could mean that a sole practitioner or partnership is incorporated into a limited company at the merger date.

If a limited company is a step too far, then consideration should be given to limited liability partnership status. This also gives the firm the opportunity for new levels of funding with increased security available.

What should the combined firms be called afterwards?

AD. There are basically three options. You either take one of the names and go with that for the enlarged firm, or you go with a combination of some sort, or you pick something completely different. Unless you have the kind of marketing budget available

to the likes of Aviva, the latter option is unlikely to be a practical option and firms should avoid going in that direction simply because they cannot agree on one of the first two options. What should happen is an objective review of the reputations and profiles involved. You pick the option that best reflects the market and not the personal views of partners.

KH. Make sure that you also consider where the firm will operate from geographically, as there may be goodwill in the name of a well respected firm in the local business community.

Dos & Don'ts

- 1. Do** have a strategy for your business including a merger strategy.
- 2. Do** move the merger forward with a healthy momentum.

3. Do Not expect certainty.

4. Do be open minded about new ideas or working practices.

5. Do maintain business as usual so that your clients do not suffer.

6. Do Not believe that the merger ends on your "Go Live" date. Post merger integration will take months afterwards.

7. Do use the opportunity to introduce other change programmes.

8. Do Not forget that the people sat across the table from you are your future partners.

9. Do deal with potential deal-breakers early in the process.

10. Do communicate openly and frequently with your people once you have decided to merge.

Solicitors' Accounts Rules - Where are we up to?

SRA Guideline 5.6 now includes the retention of the digital images of paid cheques for two years



FINALLY, all amendments to the Rules are now effective! In summary they are:

From July 31 2008:

- Introduction of specific obligations for the prompt return of surplus client funds.

- Regular reporting to the client if funds are to be retained.
- Withdrawal of small residual client balances without recourse to the SRA.
- Guidelines regarding closure of client files.

From March 31 2009:

- Introduction of LDPs and firm-based regulation following the Legal Services Act.
- The concept of a controlled trust has been abolished.
- Update and improve clarification of the Rules.

Returning surplus client money

The new Rule 15(3) imposes a specific obligation to return client money promptly, as soon as there is no longer any proper reason for the retention of the funds.

'Promptly' has not been defined by the SRA, but they state in their notes, "should be given its natural meaning in the particular circumstances...will often fall naturally at the end of a matter".

Reporting to clients

The new Rule 15(4) requires the solicitor to inform the client promptly of the amount and reason for holding any funds at the end of a matter.

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Solicitors' Accounts Rules – Where are we up to? continued

The solicitor is also obliged to report to the client, giving an explanation in writing for the continued retention of funds, at least on an annual basis.

Left over balances

Rule 22 has been amended to allow the solicitor to withdraw from client account left over balances of £50 or less, without the prior authorisation from the SRA, and pay them to a registered charity.

However, reasonable measures need to have been taken first to return the funds to the rightful owner, and appropriate internal procedures and systems need to be set up to ensure full compliance with the Rules.

SRA Guidelines for accounting procedures and systems

New paragraphs have been created and state that policies and systems should be established to deal with new Rule 22, for the timely closure of files, prompt accounting for surplus balances, and reporting to clients when funds are retained. Again, the SRA has used the word 'prompt' without giving a specific definition.

Limited Liability Partnerships

More practices are converting to LLP status and the Rules have been modified to consider this, in particular SAR 14 Client Accounts. Incorrect titles of bank accounts holding client monies have often proven to

be an area creating reportable breaches, but the changes have made the interpretation of the Rules more clear.

The Notes to the Rules

Previously, the Rules were to be interpreted in the 'light of the notes', but since the change, the notes form part of the Rules and are mandatory. (SAR 2(1))

Abolition of Controlled Trusts

All references to controlled trusts have been removed completely from all of the Rules. However, the solicitor should take care that he does not fall foul of the Trust Law, in particular receiving benefit from a trust in the form of interest received on the funds held in his general client account.

Aggregation of Client Accounts

Providing the detail given within SAR 15 note (viii) is complied with, it is now permissible for the bank to consider all client monies held, including those held on designated deposit accounts for clients, to maximise the amount of interest payable to the solicitor.

Reconciliation of Monies Withheld from a Client Account

SAR 16 note (iii) and SAR 17 note (iia) refer to money withheld from a client account but included in the monthly reconciliations. This was previously completed as best practice only, but now must be done to comply with the Rules.

Online Version of SAR

It is now permissible for the solicitor to provide access to the online versions of the Solicitors Accounts Rules only. Previously, only hard copies had to be provided.

Digital Images of Paid Cheques

SRA Guideline 5.6 now includes the retention of the digital images of paid cheques for two years. Previously the reference was only to the original paid cheques.

To discuss any areas of interest regarding compliance with the Solicitors' Accounts Rules, please contact Rebekah Holt for more information.

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