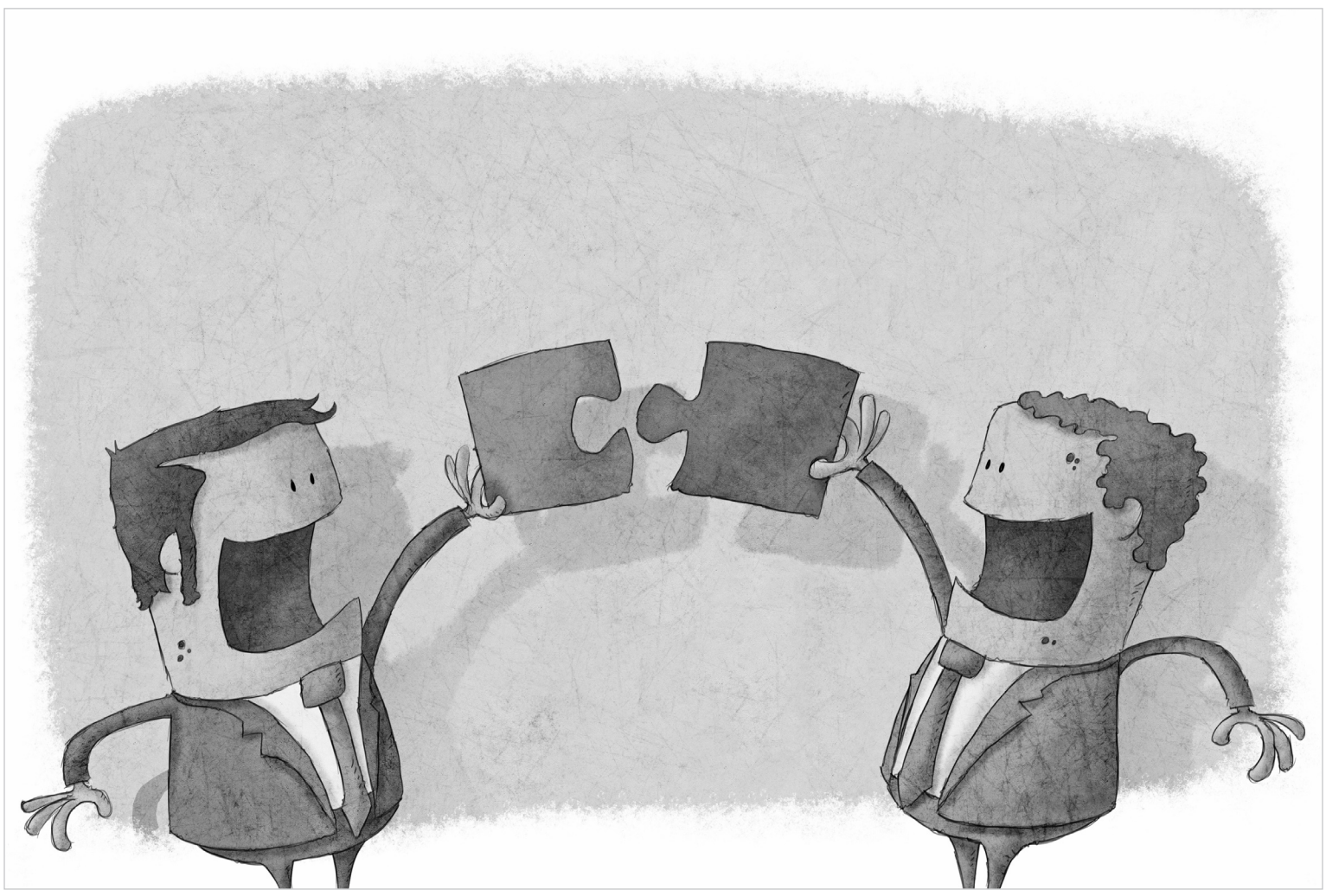
Merging firms is tougher than some think

By Edwin B. Reeser



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Managing partner expectations regarding the amount and timing for increased profits from combining law firm operations and office space is critical to any merger, yet it is typically handled poorly. There are no magic solutions to the challenge, and it isn't a big selling point to support the financial merit of most mergers.

Office space pricing and terms are driven by the local market. Even if one is fortunate enough to have below market rent on the space to be disposed, it is going to cost, and often it will cost a lot — early on in the deal. Add to that the fact that many leases have sublease profit recapture or sharing provisions, or space recapture rights for the landlord, and it is rare indeed to make a profit on office space.

The integration of operations for the two law firms also costs lots at the beginning. The frequent hoopla and promotion of savings expectations from eliminating "redundancies" in operations as a selling point of mergers are often not accurately matched up to the costs of conversion of lawyers and staff to new software programs, servers, hardware, etc. Some salaries savings on terminated personnel do occur immediately, but many terminations are gradual, as increased need for skill sets to effect the integration of technology and accounting systems require some continue for weeks or months. Mergers consume uncounted thousands of hours of additional time from lawyers and staff, and many dollars. Only once integrations are largely effected does opportunity for operational savings emerge.

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The recovery of costs expended for consolidation often takes years. Sometimes it doesn't happen at all. Examining the true costs of operations, only one-third are other than personnel. Real estate costs typically run around 8 percent of total costs, perhaps 25 to 33 percent of non-personnel costs. Examine all line-item operating cost categories and where to eke out savings from a combination. Non-personnel, non-office space costs savings won't be "transformative," and probably will be immaterial as a contributor to increased profit.

Office space savings may occur with time, but short term the cost usually goes up. Disposing of space involves leasing commissions, subtenant space modification improvements, a free rent period and frequently a discounted rental rate, so the firm is paying out more every month in primary rent than it receives from the subtenant.

Thus, the exercise in laying off surplus space is often a mitigation, not an elimination, of rent expense, and the net occupancy cost per attorney in the combined firm may actually go up for a few years. Consolidating operations in locations where there is an overlapping presence by the combining firms often involves expansion of space in one of the locations to accommodate everyone, and that means leasing more space, relocation costs, and paying tenant's share of over-standard allowance tenant improvements.

The bottom line is that most of the time, the short-term impact from a merger is an increase in costs associated with space, and that puts pressure on profits and distributable income in the immediate period following the deal.

This leads to a problem associated with these combinations and the creation of unrealistic partner expectations as to the scope and timing of when a benefit will be received by them. It is hard for a leadership to deliver a sense of opportunity and urgency to obtain partner approval for a transaction unless the bottom line to the message for partners is they are going to be better off if they vote for the deal — and soon. This is especially true for the acquiring firm partners. (We don't have to be savants in the firm that will be acquired as to how to vote if the alternative is failure of our firm and bankruptcy.) The forecasts for many mergers, in all industries, tends to be more favorable for the acquiring firm than subsequent events prove up.

It often starts with the way pre-combination financials are adjusted to reflect law firm performance, leading to an overstatement of the strength of financial position by each of the parties as they jockey for larger shares of the pie in the combined entity. That leads to a disappointment in the immediate post-merger fiscal year, with the inability to sustain the boosted prior period performance, plus the added weight of the costs and absence of savings expected.

Under strong pressure to perform to expectations they established, leadership in an entity will be hard pressed to achieve those results. Partners will expect increased distribution levels, particularly key partners in control positions at both of the law firms prior to the merger whose vote for buy-in was critical to approve the deal.

Does leadership go back to key partners, and the rank and file, and say, "we were incorrect in our forecast of cost savings and profit increases, both as to amount and timing"? Have you ever heard of that occurring? Has every law firm combination been a success? Of course not. True cost savings from operations consolidation, and office leases, if and when realized are unlikely to be so great as to underwrite the cost of a major combination of law firms. Yet in many combinations there are continuing assertions by leaders that the plan is working, and reported profits and distributions to partners go up in accord with the forecasts made. How can that be done?

Likely through crafty accounting techniques (see "Modified Cash Basis Accounting: Super Fuel for the Law Firm Drag Race," Daily Journal, May 4, 2011, available at http://www.jdsupra.com/legalnews/super-fuel-for-the-profits-per-partner-d-12701/). The danger of law firms engaging in manipulating accounting techniques to deliver more attractive financial results is that it is easy to do, quiet and undisclosed, takes no actual managerial skill or leadership, and is very hard to undo once the firm starts doing it.

The elephant in the room is what some firms may resort to in accounting treatment changes without the knowledge of many partners to perpetuate an image of success and achievement from the combination, which just isn't correct as to extent and/or timing. Pencil strokes on ledgers aren't leadership or management, they are "spin." But with absolute consequences to the entity's financial condition.

But such methods weaken the firm through enabling and then making over-distributions due to inflation of reported income levels, and consequent cash flow squeeze.

In a "liquidating merger" transaction, the acquiring firm has a luxury not available in a more equal negotiation. With the unequal bargaining power the acquiring firm can approach the deal pricing as a take-it-or-leave-it proposition, while the acquired firm isn't pricing the deal for "how much do we get" as much as they look at the specter of the crocodile jaws of bankruptcy snapping at their wallets for "how much can we preserve." Much integration cost can be laid off on the acquired firm partners, the underwriting should be more conservative, and the setting of expectations can be more accurate. Thus the prospect of a realistic forecast of outcome should be much higher, and post combination results closer to forecasts. There is then less pressure to engage in accounting legerdemain. Ultimately, that is a much better outcome for the partners of both firms.

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Mental health and ending female genital mutilation

By Arthur F. Silbergeld and Christine Robles

In 2006, an Ethiopian immigrant father was sentenced to 10 years in a Georgia prison for performing female genital mutilation (FGM) on his 2-year-old daughter with a scissors. His conviction for aggravated battery and cruelty to children is the only one in the United States despite discussion, existing criminal laws, and a horrified public reaction to the practice.

But that is changing. Britain is about to prosecute its first criminal case of genital mutilation and is educating physicians to report observations of FGM. Prime Minister David Cameron addressed a summit in July about the subject in London, which brought a promise from the U.S. to address the issue domestically and internationally. This includes financing an effort in Guinea, a West African country with high levels of female genital mutilation that could help up to 65,000 girls who have been cut or are at risk. The U.S. recently announced a multi-agency effort to prevent the practice and the Department of Justice has established a hotline for reporting the practice.

World Mental Health Day is Friday, and so here we take the opportunity to discuss some of the realities of FGM today.

FGM is the partial or total removal of the external female genitalia or other modifications or injuries to the female genitals for non-medical reasons. It is performed on girls and women of all ages, but those under 15 are most vulnerable. The damage to mental health is devastating and permanent. The procedure has no known health benefits. On the contrary, complications include severe bleeding, painful urination and menstruation, immediate and long-lasting pain, recurrent urinary tract infections, cysts, infertility, mental health issues, and complications in childbirth, including increased risk of newborn deaths. The procedure itself can result in death.

The 5,000-year-old practice is embedded in some African, Middle Eastern and Southeast Asian cultures, often motivated by beliefs that, by depriving women of sexual pleasure, it will prevent promiscuity and prepare women for marriage. But, as with denying women the right to education, this practice cannot be justified on cultural relativity grounds. In 2012, the United Nations unanimously adopted a resolution banning it.

According to the 2000 census, about 228,000 women and girls in the U.S. had been cut or were at risk of it. While this is the most recent estimate available, the Census Bureau reports that the number of immigrants from African countries alone has more than quadrupled in the past two decades, to almost 1.7 million.

Since 1996, it is a federal criminal offense in the U.S. to perform FGM on minors. The federal statute was amended in 2013 to also criminalize "vacation cutting," transporting minors to other countries under the guise of a "vacation" to undergo FGM. Federal law also mandates the Citizenship and Immigration Services to provide information about the physical harm and legal consequences related to FGM to people from specific FGM-practicing countries who receive immigrant or nonimmigrant visas.

Eighteen states have laws criminalizing FGM, including California and New York, the two states with the highest number of women at risk for FGM. In states that do not have FGM-specific statutes, prosecutors can bring FGM charges under child abuse or assault and battery laws.

Reps. Joseph Crowley and Sheila Jackson Lee of Texas have initiated a campaign that would require the Obama administration to create a national plan to study and address the cutting of American girls and update and improve statistical evidence data about women and girls in the U.S. who have been subjected to the practice or are at risk. Crowley and Lee also want law enforcement officers, medical professionals, social workers, teachers and others in contact with girls at risk for FGM educated about legal protections and supported in efforts to intervene on behalf of victims.

These proposals parallel some measures taken by the U.K. and France. The U.K. outlawed the practice in 1985, and in 2003, criminalized performing FGM on all women, not just minors, and transporting women for the purpose of obtaining FGM.

The U.K. secured funding from the European Union for an awareness-raising campaign, a hotline, and an airport monitoring effort to spot girls possibly being taken for "vacation" cutting and interrupt their foreign travel.

France has recognized FGM as a crime since 1982 after a 3-month-old girl bled to death after undergoing FGM. Although France has not enacted FGM-specific legislation, at least two practitioners and 100 parents have been convicted of FGM, the largest number of convictions in Europe.

France also has mother and infant protection services to help women who have undergone the practice in former French colonies in Africa and to explain to parents why it is important not to cut their daughters. French advocates have pushed to require doctors to check female patients to aid in prosecution efforts.

As the U.S. seeks to expand its efforts against FGM, it needs a better understanding of its scale and severity to implement effective changes. Efforts to stop this abhorrent practice need the attention and support of legal and medical professionals at all levels. We could benefit from looking to the UK and France for guidance in strengthening our efforts and aggressively prosecuting criminal offenders under existing laws.

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