Colin Rodrigues outlines the practical issues partners should consider when a merger is on the horizon

Matches made in heaven

When starting a transactional process, it is important to have a good understanding of the party on the other side of the transaction, whether that is the predator ('buyer') or target ('seller'). This principle is no different when looking at legal practices.

Without such an understanding, difficulties will often arise, and the inevitable consequence is that they will have an effect on the price a party is prepared to pay or the risk they will be willing to accept.

Legal practices operate mainly through the classic partnership or modern limited liability partnership models, though there are also a few practices that operate as a limited company. The approach any seller would normally take depends on whether they are looking to merge a firm or sell it.

Recently, the trend has been toward merger rather than sale. This is because a merger is the classic compromise of consolidation of practices of similar sizes or niche skill sets. More importantly, mergers allow partners and firms to retain their identity, so the characteristics and ethos of the smaller firm are retained instead of being destroyed. The end result is a smooth succession and continued growth of the practice, albeit in a slightly more constrained and regulated manner.

Mergers also allow an opportunity for some of the partners of the target firm to sell while others will stay on. The true test of a merger is to see if there has been retention of fee earning and non fee earning staff within the target practice 12 months after completion.

In respect of the target, the exiting partner's main concerns will cover three main areas.

Rodrigues: understanding is crucial

common to most professional practices. First, capital – the money introduced initially by partners into their practice. Second, current account, which reflects the undrawn profit accrued to the partner at any given point in time. This is why current accounts should be in credit not debit. Third, work in progress (WIP), which is usually the most contentious, since the first two figures are factual and do not rely upon a value judgment, unlike WIP. Most practices will have adopted accounting policies on the WIP valuation, such as valuing it at 80% of the attributed value entered in the management accounts. Thus only when there are differing approaches on valuation of the WIP do the problems start.

In most practices, if you reach an accommodation with the partners of the target firm on the three main points mentioned above, that is where the negotiations start or stop, depending on whether the target is a specialist practice or a particularly profitable one. As if they are then a marriage, value is demanded and the 'dowry' will take the form of a payment for goodwill. This goodwill payment is the balancing figure and represents the 'icing on the cake'.

Another area that cannot be overlooked is how the property is owned and occupied by the target. If the property is owned by the target's partners, personally or via their pension fund, it is only a question of determining how long the predator intends to occupy the same and agreeing the basis of heads of terms for a lease.

What is more difficult is when the property is owned by the target and not externally by the partners in their own names or their pension fund. This issue gets more complex still if there is a mortgage on the property. In essence, the problem will be about valuation and the ongoing cost of funding. Again, a solution could be to exclude the property from the transaction and simply grant a lease back to the predator.

The predator, on the other hand, will have different concerns. They will want to be seen as trying to meet or, at the very least, having regard for, the target's expectation on price. As cash flow is always an issue for the predator, the accommodation usually reached is over the period of payment of the consideration. Partners are usually satisfied if all their capital account and/or the majority of their current account is paid on completion. The agreement on the WIP is that it is usually paid over to the target when billed or, if you have a cautious predator, when it is collected. The predator will not want to be concerned with the debtor position of the target, so debtors are usually excluded and used by the target as a means for funding liabilities, which would not be included in the sale.

Having overcome the difficulties of price and valuation, attention must be turned to other practical issues, which are the most problematic but least contentious.

A negotiation is usually started by a chance remark by one senior or managing partner to another and then either forgotten until next time they meet. Once there is momentum in the process, one tends to find out whether there is a deal to be done. But once struck, maintaining the momentum can be difficult compared to the usual corporate finance transactions, where there are lead advisers who use the mantra of 'time is risk' as a way of energising all parties concerned.

This is why it is important to have an external legal adviser and not fall into the trap of trying to conduct the transaction in house. As well as driving the process, external legal advisers will have the benefit of professional indemnity policies should things go wrong. They will also be more forthright in tackling difficult issues with the other side.

Other practical issues will include the usual Transfer of Undertakings (Protection of Employment) Regulations consultation, approval in respect of criminal and family work, and the sticky matter of run-off insurance and the like.

In short, the process can seem a daunting one, but following a structured path will help create a firm foundation for a marriage of two legal practices – rather than a situation where the target or predator becomes someone whom you just dated.

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