

Marry in haste, repent at leisure



The business case for merger might be strong, whether it is to create a full-service firm, plug gaps in service to key clients, increase expertise, expand the client base or achieve wider geographical coverage. There are, however, significant risks, the strategic aspects of which are the main focus of many firms. FRANK MAHER, partner at Legal Risk, however, argues that firms need to pay far more attention to the dangers of operational risk in negotiating and completing a merger.

This article addresses some of the operational risk issues firms need to address in relation to undertaking mergers and acquisitions.

The first critical requirement is to examine the target firm or team's operational risk management. There are several reasons for this:

- Post-merger integration may be delayed or damaged irreparably if the issues are only discovered later;
- Indemnity-insurance issues may cripple the firm;
- Failure to do so is at the heart of why many mergers fail to achieve their strategic objectives.

With the levels of press speculation that accompany any merger, and the pressure to minimise both firms' exposure through uncertainty in the intervening period, it is understandable that some mergers are pushed through with a considerable, even indecent, degree of haste. But it is important to understand the extent to which the deal may be compromised by doing so.

Pre-merger due diligence on risk issues

To do this effectively, you – or the advisers who do the exercise for you – will need to understand how risk issues impact on professional firms. We are not just looking here at professional-indemnity issues. A useful starting point for firms of all sizes and types is the Law Society's Lexcel Standard 2004 – regardless of whether either firm has the Lexcel certification or the

merged firm intends seeking it. It is an effective checklist for many areas of practice, though there are many other lines of enquiry that can usefully be pursued as well.

Readers may find it helpful to refer to 'A practical guide to minimising risk', which explains how the Lexcel standard can form an effective framework for managing risk for law firms¹.

You will want to be sure that risk management is integrated into everything the firm does – that it is a culture, not an event. It is not just about fee earners and time limits, for example, but requires integration into all areas of the practice including its support functions such as accounts, finance, facilities management, IT, knowledge management and human resources.

A thorough process will involve detailed, structured interviews with those responsible for the various management functions within the firm – heads of department and those responsible for the support functions, including those mentioned above. Others to include will be the money laundering reporting officer, the professional indemnity contact partner and the complaints partner.

Another avenue that can be pursued, and the cost can be quite low, is the use of web-based testing systems to obtain a snapshot of the knowledge and attitudes of staff on risk issues – not only whether they have the requisite technical knowledge, but also to dig beneath the surface and find out how the firm and its culture operate in practice.

The aim will be to find out what systems are in place to give a better understanding of

how the target firm currently manages its operational risk and help define the systems that will operate in the new, larger firm.

Structure of the merged firm

Will the firm become a limited liability partnership (LLP)? This is a complex issue that may turn on accounting and tax considerations, particularly if there are annuities for retired partners. Nonetheless, the timing may be right at least to address the issue with a view to future action.

While on the subject of limiting liability – what will the merged firm's policy be to managing risk through its terms of engagement? While commercial obstacles inevitably restrict the extent to which firms can limit liability with some corporate clients, it is an area where some firms are making progress even with larger commercial clients. Even if it is not possible to impose a financial limit, there are many other useful practical steps that can be taken through terms of engagement that are unlikely to provoke opposition, such as scope of duty and allocation of responsibilities in the client engagement.

Money-laundering compliance

Although this is not the most exciting pre-merger issue on the agenda, firms will wish to be sure that those they are taking under their wing are already compliant. The Money Laundering Regulations 2003 requiring firms to put in place 'procedures of internal control' are onerous, and in many firms are currently being honoured in the breach.

Does the firm you are merging with audit itself for compliance? If not, there is little

reason to believe it is compliant. Can it produce the identification evidence when required? Have staff been trained and to what level? The issues have moved on considerably since the legislation came into force (for most firms in March 2004), and further training is likely to be required for those in higher risk areas.

The merger may present an opportunity – and a need – to introduce more advanced systems to ensure compliance. There is much that can be done with existing IT systems to this end. Data-mining systems can be implemented at quite low cost, which will help raise the standard; further discussion on that is beyond the scope of this article, however.

Many firms have aimed for the bare minimum in compliance, and, if it results in failings, they can expect to face the consequences. Those who aim high are not only more likely to be compliant, but also, if something does slip through the net, more likely to avoid prosecution.

Implementation of systems appropriate to the larger, merged firm will be an additional cost that should not be overlooked at the planning stage.

People issues

Bringing two firms' people-management and supervision systems into line can be a major hurdle.

It is all very well appointing a partner as head of department, in charge of partners from both sides of the newly merged firm. But can that partner really exercise his or her new authority in practice by walking into the room of the partner from the other side of the practice and saying, "I've just come to audit your files"? Human nature makes the process difficult, yet partner-to-partner review is recognised by insurers as being important and file audit must be part of the process.

Can the head of department announce post-merger that he or she is imposing a second-signature rule on opinion letters? Or will the embarrassment gene strike again and prevent even having a discussion on the subject?

Effective supervision, or lack of it, is an issue that affects even the largest firms and the ground rules for consistent systems need to be in place from the start. Does the firm you are merging with rely solely on its open-

door policy for supervision of assistants? Most firms claim to have an open-door culture and culture is important, but relying on that alone is a recipe for disaster. It is tantamount to a bank opening an unlimited loan account for a customer and asking the customer to monitor the account. It is not enough to rely on the assistants knowing when they have a problem before the partner is invited to help.

The merging firms need to understand each other's attitude to risk and issues such as post-signing authority need to be addressed. It will not work if one firm insists on assistants having post, or certain categories of post, signed by partners, while the other firm lets anyone sign anything. Post-merger, it can be practically impossible to impose partner-signing rules on those who have not been brought up to accept the discipline.

These are issues that have to be tackled at the pre-merger stage so expectations can be managed. The writer has seen several examples where mergers that failed to deal with these issues up front failed to achieve their objectives later.

The issue also highlights the question of adequacy of supervision – how many firms supervise partners, and how many firms have partner review in place?

Stress is an increasing issue in law firms. It is curious that the same firms that earn fees advising clients on the Working Time Directive seem to apply a policy of a 48-hour working day in their own practices.

Realistic chargeable-hours targets and total-hours targets play a part in this. So too can remuneration systems – do your incentives link to unrealistic performance targets? Enforcing the taking of holidays can play a part too. Do both firms have the same expectations in terms of chargeable and total hours, and other performance targets? If not, the issue needs to be addressed pre-merger. It will not be effective simply to announce to the target firm that from now on their chargeable-hours targets have been increased by 200 hours per year.

The problem is that people under stress do not behave in the way expected. Sometimes they can overlook the blindingly obvious: missing deadlines is a key cause of negligence claims – how, for example, can a well trained lawyer miss a three-year time limit for starting personal-injury proceedings

when that is as long as they spent at university? The answer can often be found in stress – they see the date in the diary and mean to deal with it later, but have a pile of files to deal with and fail to get round to the critical one before the court shuts at 4pm.

Stress can also make people behave in ways that appear to be dishonest, though whether they are capable of causing the necessary degree of intent for criminal action is sometimes less than clear. The writer has investigated many cases of dishonesty that have arisen from people being under financial pressure. One recent widely-reported example involved a partner who owed the bank £12m in connection with his previous firm. While some have cynically and systematically raided client funds for their own purposes – even sponsoring a Premiership football team in one case the writer investigated – those who do so solely for personal gain are probably in a minority, though some who steal when under financial pressure may later decide to exploit system weaknesses they have discovered and start enjoying the high life.

One particularly poignant example investigated by the writer involved a highly respected litigator who found she was unable to cope. She told a client she had brought proceedings to recover a £100,000 debt when she had not. She forged a judgement and sent the client a cheque for £40,000 on account, saying the defendant was unable to pay more at present but would pay instalments. In fact, the £40,000 was her own money. This is by no means an isolated example of that happening. She then set about raiding client funds to satisfy other clients whose affairs she was unable to deal with in the conventional way.

After the pack of cards came tumbling down, the solicitor was examined by a clinical psychologist who reported: "The above tests show that Miss X, while of superior intelligence, is nevertheless not really intellectually capable of dealing with the demands of her job... She therefore is suffering an enormous amount of stress by attempting to function at or above her ceiling of intellectual ability all of the time and failing to do so."

When looking at a merger or acquisition, therefore, it is important to look at the target firm's record on managing stress and whether the performance targets are in line with your firm.

MARRY IN HASTE, REPENT AT LEISURE

Finally, on people issues, are there any outstanding disciplinary proceedings against anyone in the merged firm? Have there been any in the past? Are there any partners or staff with conditions on their practising certificates or subject to orders of the Solicitors Disciplinary Tribunal?

Indemnity-insurance issues

Successor practices

To take an example, with some details changed to protect identities, a major law firm looked at acquiring a ten-partner firm, which had a number of surprisingly good clients including international, household-name companies. However, they thought three of the partners were less of a match; indeed, one seemed to sail rather close to the wind with his business dealings. So they offered partnership to the seven and left the other three to carry on as they were.

They addressed the insurance issues with their brokers and concluded that both firms were successor practices for these purposes, having regard to the definition in clause 8.18 of the Law Society's Minimum Terms and Conditions of insurance².

Some time later, it was alleged that one of the three partners who had not joined them had been engaging in international prime bank instrument frauds. Even though the large firm had wisely not taken on that partner, it looked as though they were stuck with the consequences and could readily have ended up uninsurable in the process, consigned to the Assigned Risks Pool (ARP) 'sin bin' with insurance costs for the first £1m cover up ten-fold and top-up cover probably unavailable.

Fortunately, on closer examination, it appeared that the firm was not the successor practice after all. Nonetheless, with very little variation in facts and structuring of the acquisition, it would be possible to end up with the successor practice being either, both or neither firms.

The explanation of that is beyond the scope of this article. It is not implied that successor-practice liability is invariably to be avoided, but it is a major business risk that should be considered carefully when considering mergers, acquisitions and lateral hires, and particularly when the target firm is splitting in two.

By way of example, the £3.3m ARP premium for £1m primary cover for a £40m turnover firm should be enough to concentrate the minds of most partners, not just the managing partner and finance partner.

Assessment of premium

However, these are not the only insurance issues to consider. When insurers assess premiums they take account of claims records, the balance of work, geography and any knowledge they may have of the firm with which you are merging. These are all issues to address with the insurer, through your broker, before committing to the deal.

Choice of insurer

Some insurers will not insure particular work types, so if your current insurer does not wish to cover the work type undertaken by the firm you are acquiring, that is an issue that needs to be addressed from the outset, and the partners should also be asking whether it is a risk they wish to accept themselves.

In practice, the merged firm will usually stay with the insurer of one of them, or both if they have the same insurer

Notification to insurers

This is a particularly important issue where the two firms have different insurers and one insurer will be losing the business on merger. The aim will be for the firm whose insurer is coming off risk to notify its insurers, before they come off risk, of all circumstances that may give rise to a claim. That way, any subsequent claims will fall to be dealt with by the old firm's insurers, perhaps with a smaller excess, and may also have less impact on future insurance costs of the merged firm.

The notification process needs to be managed. It is not enough to send an e-mail to all partners asking them to highlight anything of which they are aware. It is a process that must also involve all members of the support staff, even including those in the post room as well as secretaries; they may, for example, be the only ones who know about a letter being wrongly delivered with possibly catastrophic consequences – the writer defended a £3m claim arising from a letter in a wrong envelope.

Other insurance issues

You will want to know about past and outstanding claims. Are there any which could impact on the financial wellbeing of the incoming partners? Or are there any that could have an adverse impact on the firm's public image? There have been a number of reported cases in recent years where lawyers have been castigated by judges, and an increasing number of high-value claims, which have become the subject of press interest.

Those taking the LLP route will wish to consider protection for 'culpable' partners.

The successor-practice rules only apply to primary cover. There are important decisions to be made on whether top up should or should not cover a prior practice. Where you are dealing with a straight merger of two firms, you will almost invariably want this cover in place. Where, however, successor-practice liability is the undesired consequence of team acquisition, you may be more circumspect.

Multiple successor practices cause problems – not only insurers competing for claims control, but excesses on each policy.

Careful thought needs to be given to managing the publicity. If you are taking a team on and are anxious to avoid successor-practice liability, you will need to avoid any suggestion of holding out and ensure that all staff know what is expected of them in this respect too. It might only take one stray e-mail from an uninformed secretary to land the firm with an unmanageable bill for indemnity cover and claims.

Operational risk issues go to the heart of any merger. It is vital to address them before the deal is done if the merger is to succeed. ■

References

1. Published by the Law Society's Lexcel office. Available without charge by e-mailing info@legalrisk.co.uk
2. www.lawsociety.org.uk//documents/downloads/mtc2004.pdf

Frank Maher is a partner in Legal Risk, a firm of solicitors advising law firms on risk management, professional indemnity and money-laundering compliance issues. He is co-author of the Money Laundering Reporting Officer's Handbook 2004.
