Valuation of a Law Firm and a Law Practice

By James D. Cotterman

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Valuing a business concern is difficult. When that concern is a closely held business, the task is complicated by several factors. When the closely held business is a professional practice, the task is complicated further. And when the professional practice is in the field of law, the task becomes most difficult of all. What is the fair value of a lifetime of work building a law practice? This article discusses the issues and methods to answer that question.

What's Being Valued — What's Being Transferred?

This very simple question is often the one most overlooked. One cannot value a law practice without knowing what's being transferred, although many people try.

The seller is providing the accumulated efforts of establishing trust-based relationships with clients, building relationships with contacts and referral sources, creating a market presence professionally and among desired clients, and developing the infrastructure to deliver legal services.

The buyer is looking for an ongoing stream of income that is represented primarily by the client base and referral sources of the seller. The buyer is hopeful that he or she can assume the trust position with clients and the market presence of the seller. In addition, there are hard (often called tangible) assets and intangibles such as an established business operation that make up the practice's infrastructure.

The clients are looking for consistent advice and counsel; more directly, they are looking for solutions to problems or issues from someone who understands them and their needs and someone they trust.

In essence, what's being transferred can be separated into two components which will be valued separately. The two components are the business entity and the law practice. Each is described briefly below.

The Business

The business consists of the operating intangibles and the hard assets less any outstanding debt or lease obligations that are a part of the business. Such assets and obligations may include:

- cash, deposits and prepaid expenses
- land, building and improvements thereto (or possibly a long-term lease)
- computer systems and other equipment
- library and reference materials (although the Internet age has altered this aspect of the business)
- furnishings and fixtures
- accounts receivable
- unbilled fees and clients costs
- accounts payable and accrued expenses not yet paid
- loans and capital lease obligations
- client funds held in trust

The practice of law is not a capital-intensive business. Large land holdings are not required. There is minimal investment in raw materials (unless you consider the cost of attending law school!). The inventory is modest, amounting to a few months of the lawyer's time value expended on client matters (except possibly in certain contingent fee practices). There is no need for expensive equipment (as in many medical practices). Yet what investments there are have grown more expensive and require more rapid replenishment — that typewriter for your secretary that used to last twenty years is now a laptop for the lawyer and a desktop computer for the assistant — both (the equipment) needing replacement every few years.

> ***"What is the fair value of a lifetime of work building a law practice?"***

The Practice

The practice is the source of the immediate stream of revenues, as well as the network of contacts and referrals that assist in generating

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the future stream of revenues. Access is the first step, and their trust is the ultimate requirement. This is where there is significant value, or not. And it is the area in which there is the most difficulty determining what value there is and how much of it can be transferred from seller to buyer. This last question the transfer requires seller, buyer and client to make happen. This is a further reason why law practices have less value than comparably sized businesses in different settings.

A further complication arises if one looks to other professions where there is data on purchases and sales. Such transactions, often expressed as a multiple of earnings or revenues, may include some but not all of the assets and liabilities just described. One needs to be careful when looking at multiples to understand just what is included or not from the balance sheet. Unfortunately there are no databases of comparable transactions for law firms. The only available guidance comes from the surveys that look at internal transfers, which represent an okay, but not ideal, proxy for valuation. One must separate the buy-out of an ownership interest from any retirement benefit funded by the firm. In most instances these are co-mingled and not readily separable.

Special Problem of Law Practice

If, in essence, the most valuable asset conveyed in the transfer of a law practice is the ongoing and future access to contacts, referral sources and clients along with the trust they have in the seller, then essentially what is conveyed is the ***professional goodwill*** of the lawyer. The courts remain divided on this issue. And the complexity is seen in the various cases where goodwill has and has not been recognized. Clearly in some fact situations there may be an ongoing concern that is independent of the seller. It is also clear that fact situations exist where this is not the case.

Historically, the profession and the courts held that as a matter of public interest and policy, clients are *not* property and could not be sold, and that clients are ultimately free to select and change their legal representative at any time.

In matrimonial matters, both equitable distribution and community property jurisdictions have been inconsistent in their treatment of goodwill and value of practice, but this is the general area in which goodwill has traditionally been found, often embodied in the value of the professional license.

ABA Guidelines

Before 1990 the ABA position was that it was unethical to sell a law practice. And that was the position adopted by the state bar associations. In 1990 the ABA adopted Rule 1.17, Sale of Law Practice. (See the *Model Rules of Professional Conduct* and the annotations found in *Annotated Model Rules of Professional Conduct*, published by the ABA's Center for Professional Responsibility.) The Rule provides for a sale or purchase of a law practice, or an area of a law practice, by a lawyer or firm if certain conditions are met. The rule further provides for the recognition of goodwill in such sales. Lawyers should also check their state's rules as they may vary from the ABA's guidelines

The ethical considerations present problems and risks for both the seller and the buyer and center on protecting clients' rights, property and confidences. Ethical considerations cover a broad gamut of issues including: client communication, lawyer of record, client confidences, client files/property, client funds, conflicts of interest, competency, misrepresentation by seller of purchaser's qualifications, errors of the selling lawyer discovered by buyer, and other issues.

Financial aspects covered in the rules that are important in the negotiation of the transfer are the right to have a covenant not to compete provision and the fact that the buyer must purchase an entire practice or an entire practice area. The buyer may *not* select individual matters and clients; rather, he or she must accept the entire portfolio.

Valuing Partner/Shareholder Interests (The Internal Transfer)

The spectrum of law firm valuation and withdrawal entitlement theory can be characterized by two polar positions. The first considers the firm as a means to generate income (i.e. compensation), with modest, if any, value beyond the cash basis capital account. This is the dominant view currently in the profession and has resulted in the vast majority of firms valuing only the cash basis balance sheet for internal withdrawal rights. The second considers the firm as an investment, much like most other commercial endeavors.

There is readily acknowledged value in the establishment of a business enterprise. Starting a business involves creating business contacts, banking relationships, vendor relationships, designing and outfitting space, finding and training staff, creating forms and procedures and generating cash flow. These items comprise ***institutional goodwill***. Any individual who has started a business understands the value of an ongoing entity. It is for this reason that many firms will still provide something to founders beyond the cash basis capital account upon retirement. At times, the cost of buying out the founders is spread across two or three generations in order to facilitate the transfer.

When this is done for founders, and in those firms that still provide some form of unfunded buy-out, the typical methodology is to establish the adjusted net cash-basis book value of the firm plus a multiple of some average of past earnings. At a mini-

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mum this multiple will recognize the value of unbilled time and accounts receivable that are not shown on the balance sheet. In some circumstances, and with higher multiples, some recognition of the goodwill or going concern value of the business will be factored into the buyout.

The buyers, in this instance, have an advantage in that they know the seller, the clients, the infrastructure required to serve those clients and the practice methodologies being acquired. The clients should know and have relationships with some of the acquiring partners (at least if succession was planned properly), resulting in a more likely successful transition. And this is essentially the exclusive means by which law firms handled the retirement of partners before the tax law changes in the early 1980s permitted qualified pension programs for partnerships.

The Earnings Multiple

The earnings multiples for service businesses are lower than for manufacturing concerns. In professional service firms the multiples are lower yet, and law firms generally even lower than other professional service firms. Manufacturing concerns typically have ongoing franchises and productive machinery to sustain them. Sustaining the profitability of a law firm, however, greatly depends upon whether the firm is able to retain and develop its base of clients, and the lawyers responsible for attracting them.

Value in a law practice is largely personal to the lawyer and that individual's ability to attract and retain clients. The lawyer has knowledge, experience, skill, judgment, and reputation — all elements of ***professional goodwill***. As long as clients primarily hire lawyers, as opposed to firms, this will remain a guiding principle in valuing law practices. This is not to say that some firms have not created a "brand identity" that is separate and distinct to the institution. It is just that those firms are rare and not the subject of this chapter.

Complicating this task is the fact that even when client relationships are transferred, it is ultimately the new lawyer's personal ability and relationship with the client that determines whether the client will stay or leave. Therefore the transfer of a practice is a complex blend of seller, buyer and client interaction. It is for these reasons that multiples are so low.

Buy-outs beyond the return of cash basis capital in a law firm can be valued and paid in many different ways. Some plan designs are simple, while others are very complex. This variety makes comparisons of buy-outs among firms difficult. However, a present value analysis allows the various plans to be reduced to a common, comparable stated amount. Once that amount is calculated, a comparison can be made between that amount and partner earnings at withdrawal. The result is a standard multiple of compensation (earnings) that is common in the legal profession for a buy-out.

Once the standard multiple is determined, it is adjusted up or down to reflect the facts and circumstances of that firm, that practice and that market. Here are the common factors considered to adjust the multiple:

- market demographics and location,
- stability and quality of the client base,
- source of clients and referral sources,
- nature of relationships (institutional or transactional),
- ability of remaining lawyers to perpetuate the business,
- name recognition and reputations (firm and lawyers) in the community served,
- type of practice and pricing/billing/payment norms,
- concentration of revenues,
- profitability of practice relative to comparatives,
- size of firm,
- stability of partner group,
- profits reinvested into the firm to fund growth,
- level of risk undertaken, and
- quality of infrastructure.

The process of establishing an adjusted multiple is both subjective and judgmental. There is more art than science in the assignment of

Valuation Factor	Multiplier Points — Low Range	Multiplier Points — High Range
Base multiplier:	1.00	1.50
Positive factors:		
Core client group is stable and obtained through direct contact	.15	.25
Seller is young enough to effect an orderly succession	.20	.30
Consistently a very profitable practice	.50	.75
Senior partner (and then firm) are known as the "go to" firm for these services	.75	1.00
Negative factors:		
Remaining partners too reliant on senior partner for rainmaking and leadership	–.30	–.45
Firm is tied to a bad regional economy	–.15	–.25
Valuation multiplier:	2.15	3.10

bonus points or risk reserves based upon various factors.

Generally, earnings multiples fall within a range of 1.0 to 4.25. That means the value of the practice is in a range from a year of normalized annual earnings to four and one-quarter times normalized annual earnings. A second multiple often referred to is a multiple of revenues. Generally ranging from .50 to 1.50 in value, such multiples are considered less appropriate because they ignore risk and return — two critical elements of value.

The Table on page 10 depicts how one might assign factors and points for a small law firm to arrive at a reasonable multiple. Based on the Table, a benefit of 2.15 to 3.10 times earnings would appear appropriate.

With reference to the Table, the seller (retiring partner) would receive two payments for a buy-out. The first payment would be for the cash basis capital account, adjusted upward for any additional sums owed to the partner and downward for any debt the partner owed to the partnership. This amount will most likely be paid over a short one-to three year-period and is most often the same amount of time granted new partners buying-in to the practice.

The second payment would be the earnings multiple. The definition of earnings can vary but most common is an average three to five years of total compensation. There are variations on this theme, such as the average of the highest three of the final five, or of the last five drop the high and low and average the middle three. Total compensation includes all taxable income (wages, fringe benefits, employer-paid pension and employer-paid payroll taxes for those practicing in a professional corporation setting). This payment would most often be amortized over a three-to seven-year period of time. For example, if the high multiple were used over seven years then the partner would receive 44% of his average total compensation for each of the next seven years. In addition most firms would condition such payments on the actual retirement of the partner from the practice of law.

Sellers (retiring partners) should not forget to have the firm acquire a tail errors and omissions insurance policy in addition to the payments for capital and retirement. And if the partner has retired before age 65 or has a spouse under age 65, some provision for health insurance continuation should be provided. Often this would be done with the premiums paid by the retired partner. But it may complicate the mechanics of the transaction in order to comply with the insurance carrier's contract.

A special note for estate and contingent fee practices or firms with a material amount of estate or contingent fee work: these practices require extra care and special analysis, as there is future potential value that must be considered arising from past services. ◆

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Valuation of a Law Firm and a Law Practice – Part II

By James D. Cotterman

Editor's note: This is the second of a two-part article. The first part of the article was published in last month's issue of RTLM (February 2008).

When the buyer is not associated with the seller's firm, the transfer of ownership is handled a bit differently. The buyer and seller will often know of each other, but the buyer may not fully understand the seller's practice.

The first step is to learn about the seller. This is standard business due diligence. Interview other lawyers, judges, bankers, accountants and other contacts who can tell you something about the individual. Discuss the practice, the clients, pricing and billing policies.

The buyer should look to the seller to assist in the transfer of the client relationships and referral contacts. It is for this reason that so many of such deals have lives of one to three years and sometimes longer. A common procedure to facilitate a deal is to have the acquiring lawyer and the selling lawyer operate as a "firm" for a period of time.

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Value the Business

The method to value another lawyer's business is very similar to the internal transfer method of valuing the capital of a partner. Essentially, the business is valued on the net book value cash basis balance sheet. Reasonable due diligence should be conducted as one would for any business transaction. (Extensive due diligence checklists are available from the author.) Rarely will a firm have assets that require separate fair market adjustments. This usually occurs with antiques, artwork and the like. However, often those assets are the personal property of the seller and will not be part of the transaction. Items to consider:

- Review copies of filed federal income tax returns for the past three to five years.
- Protect yourself against the quality of the work-in-progress and accounts receivable and the level of debt and accounts payable. Although you may not be buying these assets and liabilities, you could inherit the problems that are hidden within.
- Review title to all assets and a detail of assets included in the transaction.
- Review all debt agreements, equipment and office leases, maintenance contracts and subscription agreements. Look for capital leases improperly classified as operating leases.
- Review all business and payroll tax returns that are required to be filed for the last three to five years.
- Review the malpractice insurance policy and applications. Determine the availability of "tail" and "prior acts" coverage.
- Review all other liability, fire and theft policies and applications.
- Interview the staff and review salaries, bonuses and benefits. Review performance evaluations, if any.
- Interview the office manager and conduct a procedures and practices audit to look for general compliance with applicable rules and regulations.
- Test for prepaid expenses, accounts payable, accrued expenses and deferred income taxes.
- Examine the trust account asset and liability, including the detail ledgers supporting the balances. Is the trust account properly established?
- Review annual client fee lists for several years and compare the fee detail lists to fees reported on the tax returns. Do a conflicts check.
- Review practice management procedures (file opening procedures, tickler systems, conflict check systems and the like).
- Review open matters, deadlines.

Value the Practice

Review the factors provided above that affect the value of earnings multiples for internal transfers. These same factors are critical for arriving at an appropriate understanding of the practice value (appropriate multiple) for an external transfer.

Valuing a practice can involve a number of methodologies. ***Looking at internal transfers as well as past transactions*** for that firm is a good way to begin to develop a valuation. Organizational documents may set forth a methodology that the owners have agreed to with respect to valuation. Remember that buy-ins are as instructive as buy-outs in determining how the owners feel about value. Look to see how that compares to any prior transactions at the firm. Unfortunately these internal reviews may involve documents and transactions that are not recent. And such deals could have objectives other than fair market value driving the ultimate agreements reached.

A second methodology used is known as the ***"multiple of income"*** approach. This method is based on the principle that value is predicated on what an informed and rational investor would pay for the company's future earnings. Profits must be "normalized," that is, adjusted for those items that would reflect the company's operating characteristics going forward after a sale.

- Use five years of financial statements to see the sustained level of and direction of performance.
- Eliminate non-recurring revenues and expenses as well as items that are not indicative of economic performance for each year.
- Consider the appropriate mix of past years of revenue to use as going forward revenues.
- Review historical gross profit margin and profit margins to see how direct costs and selling, general and administrative (SG&A), relate to revenues to determine what direct costs and SG&A expenses to subtract from the going forward revenues.
- Calculate for each year an adjustment to normalize earnings by adding back benefits, "perks" and compensation to reported net income and subtracting a reasonable compensation package. Determine what adjustment is appropriate for the going forward analysis.
- Calculate the multiple using a methodology similar to that which has been described above.
- Multiply the normalized earnings by the multiple.

While a common methodology, it requires skill in determining the economic income, future growth and the appropriate multiple. This method will often include most of the balance sheet, as those assets and liabilities are necessary to the production of the income. Excessive net assets require an addition to the final value.

A third methodology is ***capitalized cash flows.*** This method is predicated on the present value of future cash flows (as opposed to earnings). This means that earnings are adjusted for non-cash expenses such as depreciation and amortization and non-expense cash flows such as repayment of debt. The capitalization rate is the return a prudent investor would require, after adjusting for risk, over a five year period. We have used a balanced market index investment portfolio, adjusted for risk, for this methodology.

- Use five years of financial statements to see a sustained level of and direction of performance.
- Eliminate non-recurring revenues and expenses as well as items that are not indicative of economic performance for each year.
- Add back depreciation and amortization and subtract out repayment of debt to determine cash flows for each year.
- Calculate for each year an adjustment to normalize earnings by adding back benefits, "perks" and compensation to reported net income and subtracting a reasonable compensation package.
- Determine net cash flows for each year. Then calculate average and weighted average (determine what weights are appropriate to reflect the direction of performance) net cash flows for the five years.
- Determine the capitalization rate.
- Calculate the practice value using the capitalization rate computed above.

The same concerns exist for capitalized cash flows as for the multiple of earnings method above.

A fourth methodology is ***capitalized excess earnings.*** This method essentially is calculated as follows:

- Determine the firm's net tangible assets on an accrual basis.
- Reconstruct net income by adding back benefits, "perks" and compensation to reported net income and subtracting a reasonable compensation package.
- Calculate reconstructed net income for three to five years and average.
- Multiply net tangible assets from above by a reasonable return rate.
- Subtract the reasonable return from average reconstructed net income (the result is excess net income).
- Capitalize the excess net income to arrive at goodwill.

This is a widely used valuation method, but requires considerable skill and judgment to do well. And in a professional practice the concept of excess earnings is a very difficult concept to work with. See the author's article, *Unreasonable Compensation for P.C. Shareholders*, which is available free of charge from the author's web site.

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Structuring the Deal

You have probably used all of the above methods and now have a series of value ranges. See if you have any that are significantly different from the rest. If you do, then go back and understand why that occurred. Generally you will see a pattern of value that you can feel comfortable using.

You have used a mixture of historical information and adjustments to project the future economic performance of the practice. But what if you are wrong? What if the clients do not stay with the practice? Consider a structure that pays prospectively. If you are buying a future stream of income, then pay based on the future income. It's riskier to the seller, which may mean a higher multiple for the valuation. But at least it is self-funding. Since the seller is needed to assist in the transfer, this could be structured as an earn-out. The best result is that you pay even more because the combination of the seller's efforts and yours results in even more business during the transition years.

A good practice is to provide for post-closing price adjustments. Sellers generally do not like them and buyers like them to protect against downside risk. In professional service firms, adjustments based on client transfer are a bit more tricky. Good provisions contain the following elements:

- material discrepancies only;
- bi-directional in that up and down adjustments are possible; and
- limited to a reasonable post closing time period.

The Seller's Perspective

The seller of a law practice is primarily interested in assuring that his or her clients will be provided with quality legal services, that payment is received, and that personal liability is protected.

There is risk to the seller in that the buying lawyer is not competent to handle certain areas of the practice being acquired. Clients may not continue their relationship with the new lawyer. Payments may not be made.

Therefore, a selling lawyer must undertake due diligence that includes:

- Verification of the purchasing lawyer's expertise and credentials.
- Verification of the purchasing lawyer's reputation.
- Assessment of the purchasing lawyer's philosophical approach to clients and practice – will there likely be an effective relationship between seller's clients/referrals and the purchasing lawyer?
- Determination of availability of "tail" insurance coverage. ◆

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