



PREPARING TO SELL YOUR PRACTICE

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We're witnessing a morphing of massive proportions in the legal industry that many of us will not live to see again. Baby boomers are leaving the industry and will continue to exit in increasing numbers for some time to come. These smart, self-driven, hardworking lawyers have been hugely successful rainmakers. They have controlled the management of law firms as elder statesmen have resisted change and fought to maintain status quo for the remainder of their careers.

As the exodus continues, those remaining are scrambling for survival. Our industry is no longer in a youthful expansion mode. The marketplace has matured, bringing with it increased competition, lower profitability and an increasing lack of civility among colleagues. Firms are forming, dissolving and merging at dizzying speed. Lateral hiring right now looks like sharks churning the water as buckets of chum are thrown overboard. News of these changes passes in front of us daily in trade journals and social media. There are several driving factors.

Many firms have insufficient revenue to cover overhead and, in many cases, obligations to retiring lawyers. They are merging at record rates trying to bolster the revenue side, gain some economy of scale for overhead, rebalance the top-heavy pyramid, fill in the demographic gaps and provide cross-marketing opportunities. In some cases, the firm's retirement policy or the

unreasonable equity buyout demands of one or more senior lawyers leaves the firm in an economically unviable situation.

Lack of strategic planning and action — often purposely avoided by change-averse senior lawyers — have left the next generation of lawyers hamstrung and frustrated, watching competitors passing them by. Savvy attorneys are leaving to form their own firms. They want to create the culture and strategy they will find rewarding professionally and financially. At firms with no serious succession planning underway, it is impossible to hold onto the next generation. They will no longer wait for the keys to be handed over only when the senior lawyers walk out the door for the final time.

The long recession, coupled with rapidly escalating costs for people, technology, and marketing, has left many firms with deep debt. The profitability of the new normal is not sufficient for many firms to recover from their debt load. Large firms made deep cuts of service partners and excess staff early in the recession. Despite that, many slid down the slippery slope of using lines of credit to reward big rainmakers or those with compensation guarantees when profits were inadequate. Many large firms perished as a result. We have not yet seen the end of that fallout. Midsize firms mostly failed to adequately address underutilization. Many wound up becoming acquired or merging for sheer survival. The worst underperformers were left behind after the merger or acquisition. In some cases, due diligence was not well executed, and the merger or acquisition failed. Solos and smalls have had to adjust. Earnings for many have decreased.

Workload and hours have increased. Belts have been tightened. I regularly get calls from those

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who know they cannot economically survive long enough to reach their desired finish line as well as from those who, sadly, no longer enjoy the realities of the practice of law in today's marketplace.

All of the above is provided only to set the scene for those considering the sale of their practice.

The marketplace has ups and downs. Value is subjective. There is no one methodology that works for all. So with this caveat in mind, let's walk through the practicalities of selling your practice.

It took a great deal of hard work over many years to gain passage of Rule 1.17 [Sale of a Practice]. It is a game changer for solo practitioners. The officers of the PBA Solo and Small Firm Section worked tirelessly to achieve this benefit for those of you who follow. If you have not read the rule recently, you should, because it has gone through several iterations since its initial passing. For example, when it was first approved, a solo was required to die, become permanently disabled or cease the practice of law upon sale of the practice. And only the entire practice could be sold. That's no longer the case. It's now possible to sell one or more practice areas and continue to practice in an area that is not sold.

When I presented a seminar entitled "Winding Down Your Practice" at the PBA Solo and Small Firm Section Conference a few years back, my co-presenter (and former chair of the section) Marion Laffey-Ferry said, "The best time to prepare to sell your practice is the day you hang out your shingle." Of course, the ability didn't exist back when most of you started out. But the

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theory is accurate. You will need data on hand when the time arrives. You should set up your bookkeeping and procedures in such a way as to have the information available when you need it. We will return to this point shortly.

Why do you want to sell your practice?

Not everyone has the same goal in mind. It's important to determine your goal(s).

- Salvage sweat equity — Get a lump sum and spend six months to a year transitioning the clients to the new owner before enjoying your retirement.
- Make sure your clients are taken care of after you're gone without actually having to close the firm, including the return or destruction of all files, closing of the books and records and so forth.
- Have a life and a law practice, too — Work as much or little as you want and leave the continued management and marketing responsibilities of the firm to the new owner.
- Get some residual income in your early retirement years from the value of all the goodwill you created over the years from effective marketing, strong skills and exceptional client service.



How do I determine the value of my firm?

There are three accounting methods of valuation of a business: cost, market and income.

Cost generally only values physical assets such as furniture, fixtures, library, cash on hand, equipment, etc. Historical cost minus accumulated depreciation equals the firm's "book value." If the firm has a large accounts receivable balance, it may be factored and included like another asset. My experience is that most people who do business valuations for a living but lack specific legal industry knowledge generally overvalue receivables.

Market means, literally, market value. It is generally impossible to use comparables, such as in real estate for example, inasmuch as details regarding sales of law practices are not reported.

Income is the most difficult methodology to employ, but usually the best for the seller if sufficient information is available. In order to determine the value of your practice in a way that is demonstrable to a buyer you will need to know at least the following:

- Annual revenues — averaged and trend-lined over several years and including revenues by areas of practice
- Profit margin — at least of the firm; best by areas of practice: percentage of revenues remaining after all expenses, excluding owner compensation and direct benefits, are paid

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- Sources of revenue — a breakdown showing where the business comes from. This is probably the most difficult information to determine and track. You want to identify revenues from advertising; marketing activities such as seminars, publishing, networking; referrals from clients, attorneys and others as well as word-of-mouth/reputation.

In order to establish a value based on income, these factors are all relevant. For example, let's assume that a practice focuses on personal injury, workers' comp, and Social Security Disability. The firm has diligently tracked sources of revenue and determined that 60 percent of revenues are based on advertising on TV and billboard. Another 10 percent originates from relationships developed through the lawyer's religious institution.

From a buyer's perspective, at least 60 percent of the revenue stream is something that will likely continue. Depending on whether the buyer is of the same religious affiliation and how long the selling lawyer stays to help transition relationships, another 5 percent or so may also be counted on. At this point a "rule of thumb" multiplier will be applied to the income that will likely continue. If the gross margin is particularly good, a seller may get anywhere from 2 to 4 times the value of those revenues as a sales price.

By contrast, let's assume we have a more general practice, with a blend of consumer and business law, including family law, real estate, business, and wills and estate planning. The majority of business that comes in the door is based on word of mouth and the good reputation of



the seller. There is a small percentage (13 percent) of estate planning revenue that is attributable to a few referral sources. There is a more significant amount (40 percent) that is based on the inventory of wills and estate plans. Overall, revenues from this area account for only 25 percent of the firm's annual revenue.

From a buyer's perspective, there is very little ongoing revenue that can reliably be predicted and valued from the purchase. It's not too difficult for the seller to inventory the wills and estate plans and provide an approximation of size and estimated fees. Depending on the length of time the seller will remain at the firm and the amount of effort expended, a portion of goodwill of the seller may transition to the buyer.

Again, depending on how profitable the firm is, the seller may be able to negotiate a multiplier of anywhere from .5 to 1.5 times the value of those revenues as a sales price.

Does my practice really have any value?

A lot of attorneys think their general solo practice has no value beyond the actual assets. And those are likely fully depreciated. After all, it's personal relationships, built painstakingly over years of meeting and exceeding client expectations, that account for the revenue stream. And for many, today's reality is that the gross profit margin may be 25 to 35 percent. An exceptionally well-managed firm today may hold onto between .45 to .55 of each dollar after paying overhead. But most don't fare nearly that well. So what objective value is there for a buyer?



Value is subjective and relative. For example, someone with a few years of experience who wants to set up a practice may find the prospect of starting from scratch too intimidating. Those who escaped from or were ejected from Big Law may lack the necessary business management and organizational skills to launch a new practice. The actual value of your practice may be the simple fact that it exists and that you're willing and able to stay around to mentor, keep making rain and help transition as much business as possible before you retire.

Attorneys who practice in small communities often leave a vacuum when they retire. People with legal needs will continue to seek the services of a local attorney they can trust. Your endorsement helps a lot. So even though your practice may not seem to be transferable, in this setting the purchaser has reasonable assurance of making a living.

The difference in this instance is that the value is really achieved on the back end. A seller can't establish any real tangible value up front. Coincidentally, the buyer can't afford the risk of buying a firm that may or may not have a transferable revenue stream. But by providing a buyer with the opportunity to take over the practice over time, the seller can reap a small, ongoing benefit after retirement, continue to practice as long as reasonably desired and not have to close down the practice.



How do I find a buyer for my practice?

People wrestle with this quite a bit. Serendipity often comes into play. I advise attorneys to get the word out that you are looking for a succession plan or buyout. Mention it to your colleagues at bar events. You may want to let the executive director and officers of your local bar association know. Consider putting out the word on social media or in the local paper. You can hire a consultant to be an intermediary. What you do will depend on the type of work you do and what it may mean to clients (and competitors) if they hear you're looking to sell or transition the practice.

I usually recommend that any queries from clients be answered that you are making sure that you have met your ethical obligations to them to ensure they are not left hanging if anything happens to you.

Lawyers with great reputations are often surprised when colleagues approach them to ask if they've got a succession plan in place, and then invite them to spend their last years as of counsel to their firm.

One PBA Law Practice Management hotline caller was amazed that my advice provided an instant result. After discussing "getting the word out," he attended an event at the local bar association for the first time in years. He struck up a conversation with a younger lawyer seated at the table next to him. Within a week they had a transition plan. That younger lawyer had wanted to have his own practice for a while, but was too intimidated to try to do it from scratch.

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PBA members who are thinking about the possibility of selling or transitioning their practice may contact me for resources and/or to talk about it in detail specific to your needs and practice. The same goes for any members who have firms considering merger or becoming acquired. I'm here to help at any stage of your practice, from start-up to retirement.

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