

## **Valuation of a Law Firm and a Law Practice**

**By**

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Lawyers leaving a law practice have an economic interest in monetizing their career-long investment in building a client portfolio and a referral network. They have invested time, knowledge and care into relationships created to solve clients' problems, advance clients' interests and navigate clients' legal and regulatory responsibilities. They have devoted much effort to establishing professional credentials and a visible presence for their particular experience and expertise. How each lawyer has accomplished this depends on his or her particular practice, market and style. But while the means may vary, the results are the same – access to clients who have legal needs. And this is the value the acquirers wish to capture.

With a changing marketplace for legal services, many of the old rules for valuing a law firm or law practice need to be reexamined. Due diligence must be more thorough and conducted with greater skepticism. The market of sellers (retiring lawyers from the Boomer generation) is growing rapidly. At the same time, the market of buyers (the successor lawyers) have become more experienced with the challenges of transferring practices. And those clients and referral networks (the assets being monetized) have become more unpredictable. Clients are more willing to seek alternatives to the traditional, longstanding relationship with a single trusted advisor for their legal and regulatory needs. Add rapidly changing advances in technology which change how the profession works and where it works; which affects the lawyer-client relationship and ultimately the value of that relationship. And finally, potential buyers and sellers should take note of the liberalization of standards in the UK and elsewhere that, for the first time, have allowed outside investment in law firms by non-lawyers. A similar change in the US would be a potential game changer for firm valuation.

Even without the liberalization of ownership standards, the valuation landscape has changed and generally not for the better from a seller's perspective. Buying professional practices is recognized as a much more difficult activity today than it was a decade ago. Pricing models, and reasonable hopes and expectations for pricing conversion and future pricing increases are vastly different today.

Traditionally the opportunity to sell a small firm or for a sole practitioner to join a larger firm as part of a transition and exit strategy was predicated upon the assumption that clients would stay with the new firm after a short (one to three year) transition period, that the new firm subsequently would be able to convert those clients to its higher pricing models and that the year over year rate increases historically achieved would be repeated in the future. All three of those assumptions must be examined far more critically today. Clients may not “go along” with the handoff and it’s likely they will be much less willing to accept an upsell in pricing. And the rate increase patterns pre-recession are unlikely to return in the current environment. In fact, a market has developed for practitioners leaving larger, higher-priced firms to go to smaller less costly firms where they can reduce pricing to keep clients who have become quite cost conscious.

Current pricing models, along with the likelihood of client retention, successful pricing conversion and future pricing increases are all critical elements to consider in determining the value of a practice. Recent changes have complicated valuation and altered the best means to achieve a positive outcome for all parties (seller, buyer and client).

Valuing a business concern is a specialty service, built on proper experience and knowledge, good tools and data. There are accrediting organizations who provide training and credentialing for those who wish to develop a valuation practice. Such organizations include the AICPA and NACVA. And there are networks, such as the ABA (no, not the American Bar Association, but American Business Appraisers) who have a network of professionals credentialed in various aspects of valuation.

When searching for someone to assist with monetizing the value of your law practice, recognize that the practice you have built is deeply specialized. It is a closely-held business where the valuation and transfer task is complicated by several factors. Within the category of closely-held businesses, it is a professional practice which further complicates the task. And finally it is in the field of law, where the task becomes most difficult of all. What is the fair value of a lifetime of work building a law practice? This writing 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 the answer of 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 (s)he can assume the trust position with clients and 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, steady counsel and retention of their institutional knowledge; 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:** which consists of the operating intangibles and the hard assets less any outstanding debt or lease obligations that are a part of the business entity.

Such assets and obligations may include:

- Cash, deposits and prepaid expenses
- Land, building and improvements thereto (or more likely a long-term facility lease)
- Technology and communication infrastructure (probably a mix of owned, leased and outsourced services)
- Library and reference materials (in those few practices that have maintained the investment even though the knowledge is accessed electronically today – not a source of value unless it is some specialized circumstance)
- Furnishings and fixtures
- Accounts receivable (fees and client costs advanced)
- Unbilled fees and client costs advanced but not yet billed
- Accounts payable and accrued expenses not yet paid

- Loans and capital lease obligations (leasing rules are likely to change placing more operating leases on the balance sheet, but even if not, a careful examination of all operating leases is needed)
- Client funds held in trust both an asset and an offsetting liability confirmed to bank and client records
- Unrecorded liabilities or contingent liabilities arising from off the books agreements that may contain current and future obligations and claims of current and/or past employees, clients and creditors that may or may not be insured.

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 lasted twenty years is now a notebook/tablet/smartphone combo for the lawyer and an all-in-one computer for the assistant—both (the equipment) needing replacement every couple of years. Today communication bandwidth and security to support massive data transfer/storage, remote functionality and state-of-the-art video conferencing is a vastly different world than the multi-line telephone with voice mail and a dedicated fax line.

The business is valued at a point in time starting with the firm's cash basis balance sheet and adjusting from there. These adjustments are normally done in several intermediate steps; such as cash to accrual, then unrecorded and contingent items, then current value/obsolescence, then items excluded from the transaction (if any) and finally items required by the agreement at closing such as minimum guaranteed working capital or net worth.

**The practice:** the source of the immediate stream of revenues, as well as the network of contacts and referrals that assist in generating 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 where 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 (compensation of individual partners) or revenues, may be based on different valuation parameters. For example, the balance sheet may be valued separately or subsumed within the multiples being quoted. Further, the balance sheet may or may not include accrual adjustments (the most notable likely unbilled time and accounts receivable). The earnings generally are reflective of partner compensation, but cash or fully loaded total compensation? CPAs generally use cash compensation; lawyers generally use total compensation. These are nuances that must be understood before applying market data to a specific situation. Unfortunately there are no databases of comparable transactions for law firms. The only available guidance are the surveys that look at the buy-out and retirement of partners, 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 the purchase of a law practice, or an area of a law practice, by one or more lawyers or firms if certain conditions are met. The rule further provides for the recognition of goodwill in such transactions. The primary conditions to be met are that the lawyer sell the entire practice or area of practice, the seller ceases practicing law at least in the substantive area of the practice(s) sold, the seller notifies each client in writing of the proposed sale and buyer does not raise fees by reason of the sale. 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 the seller of purchaser's qualifications, errors of selling lawyer discovered by the 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 and the requirement that the seller must sell an entire practice or an entire practice area thus preventing the cherry picking of the best work/clients to the detriment of other clients.

### **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 minimum this multiple will recognize the proportional 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 which unfortunately is not done as frequently or effectively as one might expect), resulting in a more likely successful transition. 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 Traditional Look-Back Method)**

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. And in larger practices, the servicing team (including other partners and other practice specialties) influence the client's selection decisions. It is just that those firms are rare and larger practices are not the subject of this writing.

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 to consider when adjusting 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 assessment and valuation of positive and negative factors of a specific situation.

Generally, earnings multiples fall within a range of 0.50 to 3.33 (Appendix One). That means the value of the practice is in a range from a half-year of normalized annual earnings to three and one-third times normalized annual earnings. A second multiple often referred to is a multiple of revenues. Generally ranging from .25 to 1.00 in value, such multiples are considered less appropriate because they ignore risk and return—two critical elements of value. Appendix Two has a conversion chart for comparing revenue multiples to adjusted earnings multiples at various profit margins.

The following table depicts how one might assign factors and points for a hypothetical small law firm to arrive at a reasonable multiple. First you establish a base multiplier principally by size of firm, practice specialty and location. Then you assess and value positive and negative factors that should adjust the base multipliers. Based on this hypothetical example the adjusted multiplier should be 2.15 to 3.10 times earnings.

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

In this instance 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 of three to five years of total compensation. There are variations on this theme. For example, you might use the average of the highest three of final five years, or of the last five years, dropping the highest and lowest and averaging 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 their 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.

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.

### **The Profit Sharing / Earn-Out Model (A Potential Solution)**

The traditional method of looking back at earnings and applying a multiple over some payout period has also been dubbed the "unfunded buy-out." Much of the legal profession has altered its view of these programs – labeling them unworkable in their most historic form and a dangerous tax on the current earnings of mobile partners with portable books of business. Some firms have retained such plans, many with features to improve their economics. A few feel their culture and reputation are sufficient to maintain the economic expectations of successors and retirees with the arrangements in place.

Irrespective of one's view for, neutral or against such programs, there is room for improvement with two modest changes. The purpose of such programs is to recognize the value of a transferred client base and referral network. The first modification is to make the program self-funding by linking the payout to the very clients and referral sources being transferred. The second modification is to value the payout as a declining percentage of the net contribution of those clients and referral networks to the profitability of the firm.

Accordingly, the earn-out, much as with the external transfer described below, integrates itself with the future economics of the firm. Clients who stay and provide more work and more profitable work benefit both the retiree and the successors. Those clients who leave, thereby providing less work or less profitable work, diminish the amounts paid to the retirees in direct proportion to the diminished profits experienced by the firm. This outcome has a real market connection and benefits those partners who integrate into the firm with an institutional view.

Partners who do not have a client following or have clients that the firm does not want or cannot maintain will not benefit from such a model. Partners who practice in isolated silos and do little to develop a successor, preferring to leverage every ounce of profit during their own career, will have consumed all value at retirement.

### **Valuing The External Transfer**

When the buyer is not associated with the seller's firm, the transfer 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 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 these deals extend over one to five years and sometimes longer. A common procedure to facilitate a such a deal is to have the acquiring lawyer(s) and the selling lawyer operate as a joint "firm" for a period of time.

## 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. Rarely will a firm have assets that require separate fair market adjustments. This usually occurs with real estate, antiques, artwork and the like. However, often those assets are the personal property of the seller and will not be part of the transaction. If such assets are part of the transaction, then separate appraisals may be necessary undertaken by those valuation experts with expertise and experience with each class of asset.

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. New accounting rules regarding leasing are on the way and will need to be factored into any review.
- 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. Verify claims history with the carrier. 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, confirm the balance with the bank. Require representation that the balances are accurate and confirm with clients after closing. 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 and any pending 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 one 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 had objectives other than fair market value driving the ultimate agreements reached.

A second methodology used is known as the multiple of earnings approach. This method is founded 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 and net profit margins to see how direct costs and selling, general and administrative (SG&A) expenses 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 what has been described above.
- Multiply the normalized earnings by the multiple.

While a common methodology, the multiple of earnings approach 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.

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 ([www.altmanweil.com](http://www.altmanweil.com)).

### **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 try to 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 result 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:

- Adjust for material discrepancies only,
- Provide for bi-directional adjustments, so that up and down adjustments are possible,
- Limit adjustments to a reasonable post-closing time period.

### **The Seller's Perspective**

The seller of a law practice is primarily interested in assuring that his/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 if 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 purchasing lawyer's expertise and credentials.
- Verification of purchasing lawyer's reputation, including a check of malpractice claims with the purchasing lawyer's insurance carrier.
- Assessment of 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.



A word on credentialing for both buyers and sellers. Credentialing is a process whereby you confirm with the issuing organization the existence and good standing of a bond, certification, degree, or license. It is preferable to obtain certified copies of the documents for your records. Some will say this is overly burdensome and overly intrusive. And problems with valid credentials are rare. But when credentialing problems occur they can be quite troublesome.

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## APPENDIX ONE

Earnings Multiplier for Law Firms			
<u>Type of Firm</u>	<u>Low Multiple</u>	<u>Likely Range</u>	<u>High Multiple</u>
Law Firms	0.50	1.00 – 2.50	3.33

## APPENDIX TWO

Revenue multiplier – Adjusted profit margin Adjusted earnings equivalents								
<u>Revenue Multiplier</u>	<u>Adjusted Profit Margin</u>							
	<u>25%</u>	<u>30%</u>	<u>35%</u>	<u>40%</u>	<u>45%</u>	<u>50%</u>	<u>55%</u>	<u>60%</u>
0.20	0.800	0.667	0.571	0.500	0.444	0.400	0.364	0.333
0.25	1.000	0.833	0.714	0.625	0.556	0.500	0.455	0.417
0.40	1.600	1.333	1.143	1.000	0.889	0.800	0.727	0.667
0.50	2.000	1.667	1.429	1.250	1.111	1.000	0.909	0.833
0.60	2.400	2.000	1.714	1.500	1.333	1.200	1.091	1.000
0.75	3.000	2.500	2.143	1.875	1.667	1.500	1.364	1.250
0.80	3.200	2.667	2.286	2.000	1.778	1.600	1.455	1.333
1.00	4.000	3.333	2.857	2.500	2.222	2.000	1.818	1.667
1.25	5.000	4.167	3.571	3.125	2.778	2.500	2.273	2.083
1.50	6.000	5.000	4.286	3.750	3.333	3.000	2.727	2.500