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Selling Your Law Firm: What's It Worth?

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As baby-boomer solo practitioners and owners of small law firms approach retirement, many start to think about selling their practices. However, they do not want to explore that path without a rough idea of what their practice is worth. It sounds like a cliché, but a law practice is worth exactly what someone else will pay for it.

Although that answer is not very satisfactory, valuing a law practice is different from valuing other professional services businesses that are bought and sold. When this happens, appraisers routinely apply a variety of formulas. Virtually all other types of professional services, including accountancies, medical or dental practices, have fairly predictable future books of business.

The transferability of an attorney's book of business is much harder to predict. In large part, this is because many services that lawyers perform are one-time or at best sporadic. In addition, even when there is recurring business, that business is usually dependent upon certain client relationships that may not be as easy to transfer as the seller and buyer hope.

WHAT ABOUT COMPARABLES?

Comparables are of no help. The marketplace for selling law firms is immature. There are very few comparable sales. Moreover, there is no standardized way to find out what other law practices sold for. It is not like finding comparables for the house that sold down the street. Deals that are done usually remain confidential.

Even if one hears about a deal and its terms, it is hard to use this deal as a comparable. Many deals are insider ones. In other words, the parties knew each other and have worked together for years—many times in the same law firm. The actual valuation method in such cases is typically "what seems fair." For arms-length transactions, the determination of "fair" creates a much bigger problem.

Similarly, it is not much help to investigate how practices are valued in divorces. In a divorce situation, there is relative certainty about the amount of business going forward. Few factors will change. If a lawyer going through a divorce has netted \$250,000 annually for the past three years, it is very reasonable to assume that those numbers will not change significantly in the near future. In addition, the parties in a divorce *must* strike a deal or a judge will do it for them.

When a law practice is transitioned to someone else, many factors are changing. You can't make the same assumption about revenues going forward. Also, there is no court mandate in a buy/sell situation. Neither party is required to do a deal. Each party can walk.

ESTATE-PLANNING HYPOTHETICAL

Conventional wisdom holds that there is value in an estate-planning practice. Most estate-planning lawyers will have drafted many wills and other documents for clients over the course of a career. In theory, these should generate a steady stream of future business as documents need updating or an estate is probated. The purchaser of this practice is acquiring future potential business.

While there is no guarantee that this business will materialize, it is reasonable to assume that at least some of these former clients will seek out the new owner when they are in need of future legal services. In selling a law firm to a particular buyer, a retiring lawyer is actually recommending the purchaser. While some clients may certainly look elsewhere, many others will accept this recommendation and stay with the new owner.

Let's assume that a hypothetical lawyer wants to sell an estate-planning law practice that has consistently netted \$100,000 in annual revenue. Let's further assume that, over the years, the lawyer has created 1,500 wills. We can speculate that, over the next five years, 50 clients will contact the purchaser of the practice to have their wills updated (at \$1,000 per will) and 20 more will need to have an estate probated (at \$5,000 per probate). The purchaser has gained an additional \$150,000 in total revenue. These are relatively conservative assumptions.

TWO COMMON VALUATION METHODS

Is it possible to get at least a ballpark idea of what this practice is worth? Yes. Perhaps the simplest method used to value any business is the rule-of-thumb method. Here, bean-counters assign a variable (also known as a multiple). They then multiply the annual net revenue by this variable to derive a value.

In other service professions where future revenue is more predictable, this method makes sense. It makes less sense for law practices. Although there is little science to support one multiple over another for law practices, the number is thought to be somewhere between .3 and 1.0. Should a future book of business be very predictable, it could be higher.

For the purpose of our hypothetical, let's assume a conservative multiple of .5. Using the rule-of-thumb method, the value of the practice for sale is .5 of \$100,000 or \$50,000.

Another method can be used, but with this method the value is determined after the fact. Under the earn-out method, the buyer pays the seller an "earn-out"—a percentage of future revenue for a fixed period of time. If the actual revenue from the seller's files turns out to average \$30,000 a year over five years, the buyer would then pay one-third (a typical ratio) of the total to the seller. In this case, the amount would also be \$50,000.

It is readily apparent that neither the rule-of-thumb nor the earn-out method is exact. With the rule-of-thumb method, there is a lot of wiggle-room when estimating future revenue, as well as with the selection of a somewhat arbitrary variable or multiple. With the earn-out method, parties won't know the precise sale price until years down the road.

TERMS & RISK

The terms of both types of deals are very straightforward. Once a rule-of-thumb price is agreed upon, sellers and buyers need to negotiate a payout schedule. Using the hypothetical discussed above, for example, the parties may agree that the buyer pays the seller \$10,000 annually for the next five years. In an earn-out deal, three factors must be negotiated: the earn-out percentage, the length of time over which revenue will be calculated, and how frequently the percentage will be calculated and paid out.

As is the case with all business deals, there is risk involved in the sale and purchase of a law firm. When there is an agreed-upon fixed price, the buyer may pay something for nothing if the predicted future revenue does not materialize. However, if there is an extraordinary amount of future revenue, the seller may have left some money on the table by agreeing to a fixed price.

With an earn-out, the buyer assumes absolutely no risk of losing money other than perhaps a negotiated down-payment. If there's no future revenue, the buyer pays the seller nothing more. In exchange for this, however, the buyer assumes a different kind of risk. Should future revenues exceed the anticipated amount, the buyer pays more.

Given the general risk-averse nature of attorneys, most buyers prefer the earn-out method, where they pay only if the anticipated business actually materializes. Most sellers, on the other hand, would rather have the certainty of fixed payments, avoiding the risk of an earn-out where future payments could be minimal.

Few legal practices are as predictable of future revenue as estate-planning practices. Under those circumstances, what a practice is worth will be far more dependent upon the old rule of supply and demand than any formula. In short, your practice will be worth only what someone else will pay.

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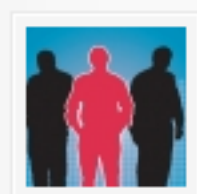
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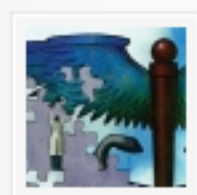
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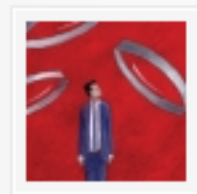
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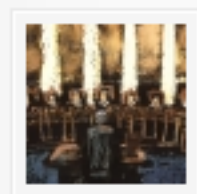
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