



What Is Your Firm Worth?

Antoine Henry de Frahan

When it comes to making money, what is the opposite of a dot.com entrepreneur in the late nineties? Answer: an attorney. Dot.com entrepreneurs managed to set up and sell businesses that had not sold any products. They made millions by “selling the factory”, without selling any actual products. Interestingly, most lawyers do exactly the opposite. They draw their income from selling their “products”, that is legal services, but don’t get a cent for selling the factory, that is the law firm. And they don’t even imagine that they could get good cash for it. Many lawyers see the law firm as a necessary supporting infrastructure, as a cost hardly worth the few non-billable hours spent on it, as an annoying distraction from their real legal job. They do not consider the firm as an investment, even less as their core investment, and definitely not as potentially the main source of their wealth. As true professionals, they are in the business of providing valuable legal advice to their clients, not in the business of building up and selling a valuable organisation. On the contrary, for genuine entrepreneurs, the most important product is not what the company is producing and selling; it is the company itself. Their main role and occupation is not to work *in* the business; they work *on* the business. For sure, that’s something that many lawyers tend to avoid as much as possible.

To be fair, some lawyers have already and properly taken care of this issue. This is what lockstep arrangements are doing: an older partner with the maximum amount of points in the lockstep draws more revenues than what he generates in legal fees. This surplus can be analysed as a compensation for his investment in developing the firm over the years. On the contrary, a junior partner might get less than what he and his team generate in legal fees: that represents the price he pays to own a part of the business that was developed by the previous generation. In other words, a lockstep is an “automatic, built-in buy-out system”.

For lawyers that are not in a lockstep, the prospect of selling out the firm, or their stake in the firm, is a bit more of a risky business. Also, the lockstep is a solution to cash on the worth of the firm, but only for selling out to partners within the firm and within the lockstep. Increasingly, however, equity investment in law firms is looking at other directions and other sources, and the lockstep may no longer offer the right solution in these new situations. Let’s discuss these two issues.

No lockstep, no value?

Imagine the founder of a firm. At age 65, he has devoted his entire life to building a successful, highly reputable and profitable practice. He is assisted by several senior associates. He wants to retire and “sell” the firm to the senior associates, making them equity partners. At that point, the big question for him may be, “How much cash do I deserve for transmitting the ownership of the firm?” If he takes into consideration all the efforts and energy he has invested in the firm, he is likely to end up with a seven figure in mind. But how do the prospective buyers see this? What is the actual value for them of buying the founder’s stake? The seller is selling the past, but the buyers are interested in buying the future.

Maybe, the prospective buyers, having worked for some time in the firm, have already established solid links with key clients and these clients would follow them anyway if they ever decided to move out. So what would they pay anything to the founder for something they already possess? Although nobody disputes the heroic efforts of the founder, when it comes to putting money on the table, there may not be many candidates, and the amount proposed is likely to fall deep below the founder’s expectations. The buyer may be facing the destructive conclusion that his firm, or at least its stake in the firm, is worth nothing...

We are convinced that, to avoid these dramatic situations, the succession of a partner must be prepared and start very early in a career. When the actual departure looms at the horizon with a few years or months to go, it is often too late to work out a solution where everyone will experience a win. Many life-long relations end up in bitterness because of this lack of foresight about succession. The system must be set up *in tempore non suspecto*. Precisely, the advantage of a lockstep is to engage the succession process as early as when one becomes a partner.

More generally speaking, your firm or your stake in your firm will never be worth more than the amount that a buyer is willing to put on the table. Long and complex financial assessment by accountants may result in a price tag, but if no buyer is willing to pay that amount, you as seller won’t get a cent. Your firm may theoretically be worth something, but without a market you won’t get a cent for it. The virtue of a lockstep is to institutionalise an (internal) market and therefore to guarantee to partners a compensation for their stake in the firm.

Valuation for third parties

The cosiness of the lockstep, where stakes in the firm circulate among partners at an agreed, predictable and convenient valuation, may however be insufficient. Indeed, law firms are starting to look outside the partnership for equity investments. From hiring of lateral partners to soon-to-happen investments by private equity funds to full-fledged IPOs, law firms are likely to face the question of valuating their business in a more challenging way.

In these situations, what will determine the value of the firm? Faced with this difficult question, many lawyers tend to believe that a technical analysis should provide a clear and objective answer. So, lawyers' instinct is to turn to an accountant or to an investment banker to come up with a final figure based on a seasoned analysis of the firm's balance sheet and P&L. Financial experts may provide useful ranges, but there is no such thing as "the" value of a law firm. There cannot be a neutral, scientifically established figure. The value is always determined by the context of the transaction and by the interests of the parties involved in the transaction. They may have different priorities, different interests, and different agenda, resulting in different views about the value of the firm. Ultimately, the value of the firm will be a matter of negotiation and agreement. The outcome will depend at least as much on the bargaining power of the parties as on the features of the firm.

Before putting any figure on the table, the first step towards valuating a law firm is therefore to set out the specific context of the transaction: What transaction is being considered? Why? Why now? Who are the parties at the table? What are their motives?

Another important question is to determine exactly what the seller sells, and what the buyer buys. This may not be the same thing! Quite often, the buyer and the seller are not talking about the same "product", and that may create big disappointments when it comes to valuation.

Is the buyer just buying the hard assets of the firm, from PCs to software and database to library to parking lots? Is the buyer buying a client base and a predictable flow of business from it? But to what extent is this client base predictable and attached to the firm itself, not to the partners who sell and leave the firm (in which case the firm may be worth nothing for a third party)?

These questions show that to create value within their business, attorneys must gradually separate their business from themselves. The business must be "transportable". When clients are too strongly attached to a particular partner, which is often the case by the way, the residual value of these clients for the firm and for a prospective buyer is close to zero when the partner is gone. For a partner, getting the hands off the legal work and making himself dispensable is often a condition for creating a legal business worth selling. ■