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WHAT IS YOUR LAW FIRM WORTH?

By Peter A. Giuliani

Throughout their life cycles, most law firms often encounter two significant events that give rise to questions about the value of the firm. The first such event is usually the first time the founding partner(s) seek to admit a new equity partner. The second such event is usually the retirement or withdrawal of one or more of the firm's founders.

Strictly speaking, a law firm is worth only what a **qualified** and **informed** buyer would pay for it. Since law firms can be owned only by lawyers, the field of **qualified** buyers is limited. An **informed** buyer would be a lawyer or law firm that has intimate knowledge of the subject firm's client base, skills base, reputation and finances. That limits the field even further. Let us assume, for the moment, however, that such a buyer exists. How does the prospective buyer go about determining a fair value for the subject firm?

The first thing a buyer looks at is the *"Tangible Net Asset Value"* – a short-hand way of saying *"Excess of 'book' assets over liabilities."* The kinds of things that go into this calculation are:

- Cash and cash-like items
- Costs advanced to clients (i.e., *"hard disbursements"*)
- Furniture, fixtures and equipment, net of depreciation
- Leasehold improvements, net of amortization
- Bank debt
- Other indebtedness, like credit lines, letters of credit, etc.
- Unrecorded liabilities, like an obligation to pay contractual retirement benefits

While the firm's financial statements are a useful starting point for this simple calculation, an **informed** buyer would want to question the collectability of client costs advanced, the age and replacement value of furniture and equipment, and the remaining term of the firm's office lease, relative to the unamortized leasehold improvements (if the lease is about to expire, will the firm have to move and abandon the leasehold improvements? If so, they have little or no value). Remember, the buyer is looking at how these assets are going to benefit him/her, not what they originally cost.

The second major thing the buyer evaluates is the quality of unbilled and billed-but-uncollected accounts. While these assets are not recognized under the cash-basis accounting, they are very real assets, because they provide sources of cash to finance short-term operations. A buyer wants these assets as part of the deal, because if they were not available, the buyer would otherwise have to finance rent, staff salaries, etc. until work currently being done by the firm's lawyers gets collected.

The best way to value these assets is to make a good faith estimate of when and how they will turn into cash, subtract scheduled operating expenditures from estimated cash collections, and estimate the excess after-tax profit such assets are expected to generate. Bear in mind that, even though most law firms are not taxed at the entity level, partners do have to pay personal income tax on their earnings. The taxes on *"ready cash"* have already been paid; the taxes on accounts receivable have not.

Third and finally, there is the thorniest question of what the firm may be worth as a *"going concern."* This value is a function of how much cash the operation of the firm is expected to throw off for the benefit of the new owner(s), assuming that the former owner(s) is no longer actively involved with the practice and is no longer being compensated. If, for example, the former owner's practice was so uniquely personal to him/her that clients would look for other counsel if (s)he were not in the picture, the likelihood that the practice/firm would throw off any meaningful cash – over and above collection of outstanding accounts – is slim to none. Thus, any *"going concern"* value would be zero.

If, on the other hand, the client relationships that are being left behind are really bonded to the firm, as opposed to the former owner(s), there is a *"going concern"* value to the new owner(s). How much a would buyer be willing to pay for the "going concern" value is a matter of balancing the expected cash generation with what the buyer might be able to earn from a similarly-risky alternative investment. For example, let's say that the subject firm or practice is expected to generate $50,000 per year in excess cash after all employees and the new owners have been paid a reasonable compensation. Let us further assume that the best alternative stock investment might earn the buyer a return of, say 5% per annum, after taxes. For a five-year bet, the buyer might be willing to pay a maximum the present value of $50,000 per year, discounted at 5% per annum – or about $216,000.

Practically speaking, the process of valuing a law firm is a lot more complicated that what is described in this article. The three fundamental principles are, however, the basic building blocks of any kind of business valuation and should apply equally well in a law-firm setting. Any practitioner contemplating a transfer of his/her practice should keep these principles in mind.

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