Succession Planning for Attorneys and Law Firms

Ronald L. Seigneur, MBA, CVA, CPA/ABV

According to Lou Harris and Associates, 53% of the U.S. Workforce expects to voluntarily leave their jobs in the next five years. A recent study by the Conference Board[1] finds that by 2010 about 64 million American workers, 40% of the nation's workforce, will be poised for retirement.

At the same time, studies have shown that the growth of nation's labor force will slow from 1.2% annually to 0.6% in 2010 and continue to decelerate to 0.2% between 2015 and 2020, causing a severe shortage of qualified workers in many sectors of the economy. Adding to this is a changing attitude toward work itself, which can be summed up with the notion that while the baby boomer generation now exiting the workplace was generally a group who lived to work, those now entering the labor market tend to often hold the converse view in that they work to live. Over the next 10 to 15 years it appears likely that we will see an unprecedented number of American workers headed for retirement, while at the same time the influx of qualified talent will tighten.

A 2004 study conducted by the Private Companies Practice Section of the American Institute of Certified Public Accountants revealed that 60% of CPA firms have owners between the ages of 55 and 62, with 74% of these firms predicting that one or more members of ownership will retire within the next 5 years[2]. The real shocker is that 81% of these same CPA firms said they had no documented succession plan in writing. While the author could not find comparable statistics on private practice law firms, it is not unreasonable to assume that similar trends and demographics exist within the legal community. Given the massive transfer of management and leadership as these individuals begin to retire, together with the shortage of workers many are predicting in the years ahead, these trends should be a call to action for all professional service firms, including attorneys, who want to be proactive in addressing the succession planning needs within their enterprise.

The balance of this article will provide guidance on how to implement a succession planning process and the core attributes of a solid plan. A well thought out plan can not only assist in providing a smooth transition between ownership and leadership within a law practice, it can also build the continuity required to protect one of the most important assets within the firm, the trained workforce in place within the organization. This extension of enterprise life, through a properly articulated and implemented succession plan, can serve to strengthen core values and increase the value of the practice itself.

The first place to start is to fundamentally recognize the need to begin planning now for succession issues that may appear to still be many years off. In a law firm setting, this should also entail an assessment of the benefits to the exiting practitioner of succession planning, given the common notion that there is little or no economic value associated with a professional law practice. While we will touch upon the economic aspects of a properly orchestrated law firm succession plan a bit later in this article, there are obviously other important reasons to undertake the effort, including the transition of client responsibilities and relationships, replacement of skills and expertise that will be lost, and governance and leadership issues for the enterprise. All of these issues are long term in nature and thus each is a call to action early on.

Once there is appropriate buy in from both those who will be more likely the first to leave, as well as those who will succeed to what those leaving leave behind, the owners of a law firm can begin to treat succession planning as an activity that can be incorporated into the firm’s everyday activities. Examples of these activities include the coordination and implementation of enhanced training and mentoring to insure the skills and expertise of those who will leave can be passed on to younger practitioners, evaluating required changes to the methods used to compensate those that contribute to the success and continuity of the enterprise, identifying and elevating the involvement of tomorrow's practice and firm wide leadership, and upgrading the approaches taken to introduce key clients and referral sources to begin the transition of those relationships.

The firm's ownership should also assess what is in place in terms of a formal buy-sell agreement as the cornerstone document for memorializing the rights and entitlements associated with the entry and exit from the practice. The buy-sell agreement provides the roadmap necessary to optimize the continuation of the practice upon what is often referred to as a "triggering event". A "triggering event" can include many of the contingencies that cause an event to occur, such as death, disability, retirement, departure for competitive practice, and involuntary termination. The key consideration here is to make a candid assessment of what the firm currently has in place versus what is truly needed to serve the needs of all affected parties under a myriad of situations. Aligning this assessment with the expectations of those who will be impacted by the terms of the buy-sell is an excellent way to identify divergent views early on, as opposed to at the time of a triggering event. Look at the status of this aspect of the overall planning process as if you were your own client in terms of whether or not the agreement you think you have in place to deal with these issues is in final form and fully executed and enforceable among all who may be impacted by it. In the author's experience, these agreements are often in some state of flux, not fully ratified by the parties to the agreement, or in need of critical adjustments to incorporate the intended desires of all on a basis that protects the parties from future disagreements upon a "triggering event".

A large part of the overall succession planning process involves the economic aspects of the plan in terms of who will be entitled to what upon an exiting event, together with setting an appropriate framework for what will be expected from those who will continue with the enterprise. While much of this is obviously dependent on the size and nature of the practice itself, the core concepts can be enlightening regardless of whether the subject practice is a sole practitioner or a large diversified multi office firm.

It is common knowledge that a traditional CPA firm will typically sell for one times annual gross revenues on an earn-out basis. The standard model for this earn-out aspect is for the selling party to receive a down payment of 20% of the current year's revenues at closing and an additional 20% of collected fees for each of the next four years. The beauty of this approach is that it motivates the seller to do whatever can be done to transition the client relationships and the buyer is protected beyond the initial down payment for the client business that chooses to go elsewhere over the earn out period.   A key here in order to relate this type of transactional model to a law firm setting is to understand what is meant by a "traditional" CPA practice. Most often, this type of practice is focused primarily on a balance of tax planning and compliance services and financial attestation services which most often relate to clients that have at least an annual need for identifiable recurring services, such as annual income tax returns or audited financial statements. It is this recurring work opportunity aspect that gives rise to most of the value that is capable of being transitioned.

The one times collected gross revenues multiple quoted above for the sale of a CPA practice is often negotiated up or down depending on an analysis of the following attributes of the particular practice:

- Scope and nature of services offered
- Quality of the clientele and the likelihood of being able to align them with new service providers
- Quality of the personnel and facilities, if any, to be transferred
- Overall profitability of the practice

All of this can be applied to an analysis of a law practice for the purpose of assessing its value whether to be used for negotiating an outright sale of the practice or for application within a buy-sell arrangement for other "triggering events".   Given the relatively recent ability for an attorney licensed in Colorado to consider an outright sale of his or her practice under Colorado Rule of Professional Conduct 1.17[3] (RPC 1.17), this type of analysis becomes even more relevant as more legal practitioners begin to comprehend that there is potentially significant value associated with their law practice that in many situations can be transferred for value. In a law firm setting, it is the transferability of attractive, recurring work opportunities, similar to that that exists in the CPA firm setting described above, that drives the potential for value to the exiting practitioner.

RPC 1.17 was incorporated into the Colorado rules in response to the ABA Model Rule 1.17 (MR 1.17) that addresses the same basic issues upon a sale of a law practice. It should be noted that Colorado RPC 1.17 differs significantly from ABA MR 1.17[4]. Generally, Colo. RPC 1.17 is more detailed and lengthier than the ABA MR 1.17. Additionally, Colo. RPC 1.17 incorporates certain comments to the ABA rule directly into RPC 1.17 with its sections (d), (e), (f), and (g) that have no counterparts in MR 1.17. Unlike MR1.17, the Colorado rules does not require a lawyer who is selling a practice to cease the practice of law. Colo. RPC 1.17 requires several additional notice requirements to clients regarding the selling lawyer and purchasing lawyer, and adds several client protections, including a provision that requires the seller of a private law practice to inform his or her current clients of the client's right to retain other counsel or to take possession of the file.

Regardless of whether a practitioner is seeking to avail himself or herself of an outright sale of their practice under these rules, or otherwise be looking to obtain the value associated with their practice under any of the other "triggering events" of a properly structured buy-sell arrangement, the underlying dynamics of the practice itself will dictate what the value is. For example, a law practice focusing on wills, probate, and estate planning will have a much better chance in transitioning a client base to one or more successors, versus a complex litigator that is hired routinely for his or her reputation in trying complex litigation matters. Often it becomes an issue of identifying what the brand is that clients and referral sources look to in making their purchase decisions and then developing a strategy to transfer that brand identity to either one or more other successor practitioners or to a firm itself as the surviving institution.

This concept of branding is critical to focus on early in the succession planning process. Many professional practitioners believe the only significant value associated with their practice resides in their professional goodwill and that this is not readily transferable since anyone who buys services based on the reputation and overall standing of the individual will not be inclined to buy services simply from another practitioner or firm recommended by the professional upon their exit for whatever purpose. With the implementation of logical, coordinated actions over time, it is reasonable to assume that some portion of the value proposition associated with this professional goodwill can be re-branded to be increasingly associated with other individuals and in a firm as the institution in place to serve the clients needs. Again, it is noted that certain types of practices will lend themselves to be better candidates for this re-branding concept, but nonetheless, with a long term commitment to putting the proper people in place and in transitioning the required work relationships, most any type of law practice can benefit from this with the payoff being more recurring work opportunities for the practitioners interested in succeeding to the practice of an exiting individual.

In building a workable succession plan that has the buy-in of all players, it is paramount that the appropriate incentives be provided to attract the practitioners to structure an arrangement on a basis that makes sense to them. Many second and third generation law firms are currently in a mode whereby the founders and prior practitioners were provided generous terms, comparatively speaking, to redeem their ownership interests and those now current owners that have fulfilled these prior transactions are finding that those following along below them are not willing to provide the same entitlements in return for access to the continuing practice and its ownership. Assuming the firm and its infrastructure is solid, these younger practitioners view the economic side of succession planning as something where they are only willing to pay for the incremental opportunity to do more appealing work, work for better or more prestigious clients, and to bill at higher rates, all in relation to their current standing within the firm, or as compared to their next best alternative in the marketplace that can be realized by simply moving to another firm.

It is also critically important for those to be affected by a succession plan to be focused on the non economic aspects of why it is important to undertake the effort. In many instances a succession plan is put in place more to secure the continuity of the enterprise for reasons of professional and personal pride and to simply allow the enterprise to carry forward with its purpose solely for the benefit of those that follow. For example, the ownership of a small firm may feel a high degree of responsibility for maintaining the enterprise to provide for the employment of staff that might otherwise lose their positions when a firm closes its doors.

There are many other aspects associated with succession planning principles for professional service firms that are beyond the scope of this article, such as the interaction of an appropriately structured buy-sell agreement with the firms other operating documents, including a partnership agreement or corporate articles and by-laws. Every firm should assess where they stand in terms of the need to undergo a succession planning process and the best place to start is to solicit input from the current members of ownership to determine an estimated timeline for the contemplated retirement of each owner. If your firm has one or more members of ownership that are looking to retire within the next 5 to 10 years, it is not too early to begin putting more emphasis on this aspect of a well managed professional practice.

Ronald L. Seigneur, MBA, CVA, CPA/ABV is a partner in Seigneur Gustafson Knight LLP, located in Lakewood, Colorado. Mr. Seigneur has over 20 years of experience working with law firms and attorneys on a wide range of practice management issues, valuation, economic damages and litigation support matters. He is co-author of Financial Valuation: Applications and Models and an adjunct professor at the University of Denver College of Law where he teaches financial, management and leadership courses. Contact Ron at ron@cpavalue.com or (303) 980-1111.

[1] The Conference Board 2005 Annual Report, New York, NY.
[2] http://pcps.aicpa.org

[3] **Colorado Disciplinary Rules of Professional Conduct - Rule 1.17 Sale of Law Practice**

A lawyer or a law firm may sell or purchase a private law practice, including good will, if the following conditions are satisfied:

(a) The entire practice is sold to one or more lawyers or law firms.

(b) The fees charged clients shall not be increased by reason of the sale, and a purchaser shall not pass on the cost of goodwill to a client. The purchaser may, however, refuse to undertake the representation unless the client consents to pay fees regularly charged by the purchaser for rendering substantially similar services to other clients prior to the initiation of the purchase negotiations, except that any written fee agreements between seller and clients must be honored.

(c) Written notice of the pending sale shall be given at least sixty days prior to the date of transfer of responsibility for the client's file. Incident to the sale the seller shall provide to such client, via certified mail, return receipt requested, directed to the client's last known address, written notice, which shall include:

(1) notice of the fact of the proposed sale;

(2) the identity of the purchaser;

(3) the terms of any proposed change in the fee agreement permitted under paragraph (c);

(4) notice of the client's right to retain other counsel or to take possession of the file; and

(5) notice that the client's consent to the transfer of the client's file to the purchaser will be presumed if the client does not retain other counsel or otherwise object within 60 days of receipt of the notice.

If the purchaser has identified a conflict of interest that the client cannot waive and that prohibits the purchaser from undertaking the client's matter, the notice shall advise that the client should retain substitute counsel to assume the representation and arrange to have the substitute counsel contact the seller.

(d) The notice may describe the purchaser's qualifications, including the seller's opinion of the purchaser's suitability and competence to assume representation of the client, but only if the seller has made a reasonable effort to arrive at an informed opinion.

(e) If certified mail is not effective to give the client notice, the seller, or the purchaser in the event the selling lawyer is deceased or disabled, shall take such steps as may be reasonable under the circumstances to give the client actual notice of the proposed sale and the other information required in paragraph (c). If no response to the notice is received within 60 days of the mailing of such notice, or in the event the client's rights would be prejudiced by a failure to act during that time, the purchaser may act on behalf of the client until otherwise notified by the client.

(f) The sale of the goodwill of a law practice may be conditioned upon the seller ceasing to engage in the private practice of law for a reasonable period of time within the geographical area in which the practice had been conducted.

(g) If substitution of the purchasing lawyer or law firm in a pending matter is required by the tribunal, the purchasing lawyer or law firm shall provide for same promptly.

(h) Admission to or withdrawal from a partnership or professional company, retirement plans, and similar arrangements, or a sale limited to tangible assets of a law practice is not a purchase or sale for purposes of this rule.

[4] **ABA Model Rule 1.17 - Sale of Law Practice**

A lawyer or a law firm may sell or purchase a law practice, or an area of law practice, including good will, if the following conditions are satisfied:

(a) The seller ceases to engage in the private practice of law, or in the area of practice that has been sold, [in the geographic area] [in the jurisdiction] (a jurisdiction nay elect either version) in which the practice has been conducted;

(b) The entire practice, or the entire area of practice, is sold to one or more lawyers or law firm;

(c) The seller gives written notice to each of the seller's clients regarding:

(1) the proposed sale;

(2) the client's right to retain other counsel or to take possession of the file; and

(3) the fact that the client's consent to the transfer of the client's files will be presumed if the client does not take any action or does not otherwise object within ninety (90) days of receipt of the notice.

If a client cannot be given notice, the representation of that client may be transferred to the purchaser only upon entry of an order so authorizing by a court having jurisdiction. The seller may disclose to the court in camera information relating to the representation only to the extent necessary to obtain an order authorizing the transfer of a file.

(d) The fees charged clients shall not be increased by reason of the sale.