

Law Firm Valuation

An Interview with James D. Cotterman

In January 2018, Dario Buschor interviewed Jim Cotterman as part of the research for his Master Thesis on Law Firm Valuation. The transcript of that interview was included as an appendix in his thesis submission and is reproduced here with the author's permission.

Dario Ramon Buschor

Mr. Buschor studied Law and Economics at the University of St. Gallen, a research university in St. Gallen, Switzerland. After obtaining his master's degree, he is now preparing for the bar exam as well as working on his Ph.D. focusing on law firm governance and leadership in law firms.

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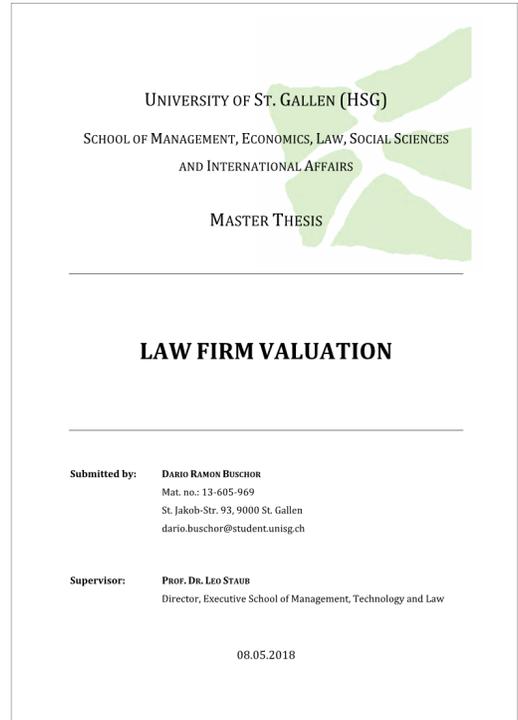
James D. Cotterman

Mr. Cotterman is a principal with legal management consultancy, Altman Weil, Inc. He advises law firms on compensation, capital structure and other economic issues, governance, management and law firm merger assessments.

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Read more from Jim Cotterman:

www.altmanweil.com/LawFirmValuation



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ANNEX B: Interview with JAMES D. COTTERMAN

Date: 5 January 2018, 3:00 pm – 4:05 pm

Form: via telephone

JAMES D. COTTERMAN is an experienced law firm consultant and principal at **ALTMAN WEIL, INC.**, a renowned legal management consultancy firm headquartered in Philadelphia. Not being a lawyer himself, **MR. COTTERMAN** gathered broad experience in the legal sector during three decades of working with **ALTMAN WEIL**, specializing in compensation issues, capital structure, management and law firm merger assessments. He is the author of various articles on different subjects as well as the man behind *Cotterman on Compensation*, a blog focusing on lawyer compensation and law firm finance. **MR. COTTERMAN** is also a frequent speaker and lecturer, including regional and national events of the ABA. **MR. COTTERMAN'S** remarks are related to US market dynamics and while we use the term partner and partnership, we recognize that US firms may also organize themselves in a corporate form.

(DARIO BUSCHOR:) My thesis focuses on the valuation of law firms. While extensive literature is available on the matter of business valuation as a whole, the subject of law firm valuation seems not to be the topic of many writings. Your article "Valuation of a Law Firm or Practice" is the most easily encountered and most extensive contribution on the subject of law firm valuation.

(JAMES D. COTTERMAN:) Law firms are very different from other businesses because they are closely-held professional service firms. And in contrast to other professional service firms, they are more highly regulated with respect to ownership and restrictive agreements. Another uniqueness is that there is no comprehensive data on law firm valuations publicly available. That said, usually no payments are made when one law firm is "acquired" by another law firm, except for the capital the partners might get back at some point. When consideration is paid, it is more likely to be in the form of an earnout – payments over time based on the economics of the transferred practice.

Contrary to firms in basically every other industry law firms do not seek a business valuation when considering a merger, or if they do so, not to begin with. In what events are valuations of law firms most common?

Law firm valuations are most common in the events of the death of a partner, dissolution of marriages or sale of a practice either by means of an orderly internal transition from one lawyer to a successor lawyer or the absorption of the practice by another firm. In some instances, the valuation methodology is well specified in the partnership agreement and agreed to by all interested parties. In other situations, there is imprecise language or disagreements or lack of trust that makes the process much more difficult. In the case of a law firm sale, time is of the essence because the clients, the main source of value, won't stay with a firm not ready and able to handle their legal needs. In the case of a valuation following the dissolution of a marriage, the primary subject of the valuation is usually not the law firm itself, but rather the lawyer's license and as such an interest of the former spouse in the lawyer's earning capacity. In this instance the value of the firm is usually relegated to the value of the capital account.

In each situation, the restrictions on who is qualified to have an ownership interest in a law firm, limits the number of potential buyers. Interested individuals should review the ABA Model Rules of Professional Conduct (particularly Rule 1.17) and the local jurisdiction's equivalent rules on the sale of a law practice.

No matter the circumstances, one will see that at the end of the day a law firm itself only carries a very limited value in itself relative to what is seen in other businesses.

When valuing a law firm what is valued in the end? What does one have to focus on?

A law firm valuation is of importance when two parties are negotiating a price for a practice or firm to be taken over. In addition to the physical assets, such as the office and all equipment, the obligations (payables, debt and lease obligations) the buyer wants to buy the seller's clients (or rather the future profits from serving those clients), reputation and other intellectual property. Basically, the buyer pays the seller for net cash basis equity of the firm plus the rights to collect profits on the services he will render for the clients of the transferring lawyer. However, in the US, lawyers are not allowed to sign non-compete agreements (NCAs). Consequently, no buyer will be prepared to pay a lot of money risking that the seller will open a practice across the street and by doing so will most probably induce all her existing clients to follow her. Generally, the only situation where a lawyer can enter into an NCA is in the event of retirement. The payments will then be structured as a series of retirement payments.

However, let me use a related brief real life story to illustrate just a bit of the unique situation with professional services: During some time a dentist's practice was very successful, so that the dentist decided to employ a younger dentist to help him handle all the patients. At a certain point, the older dentist decided to retire and proposed to sell the practice to his younger employee. The young dentist happily agreed to take over the practice. They readily agreed to the particulars regarding the office lease, equipment and the like. However, he refused to pay anything in addition for the patient list. His argument was that he knows all the patients and they know him – his remarks being that it was his hands inside their mouths for the past many years. He does not have to "buy" those patients; they already trust him and will stay with him as soon as the older dentist retires. Thus, the challenge is valuing and structuring such transactions and the practical need to reach an agreement on buy-outs before they are imminently needed.

The most valuable asset seems to be the client base. But not only is it hard to value such client base, in addition a change in demand from the client side can be observed. Clients demand more transparency, lower fees, are less loyal to their trusted firms and at the same time demand more loyalty from their law firms.

Clients, particularly the large corporate clients, are more likely today to approach their law firm relationships in a way that is more akin to a vendor relationship. As you mentioned they seek greater price transparency, more overall cost certainty and are willing to competitively bid for their legal services. Many clients compare and change providers of legal services more frequently than in the past or consolidate work among a smaller number of providers in an attempt to improve the value of the arrangements. While in earlier days about 5% new clients had to be acquired every year in order to maintain a steady revenue flow in a general practice, nowadays this number is more like 10%-15% or even higher. In addition, client demands increased, they now look for more from their law firms than legal advice and ask for seminars, secondment lawyers and the like while at the same time putting pressure on the price. And not only that, while loyalty from the client side is decreasing, business conflicts for lawyers are increasing. Business conflicts exist apart from the strict ethical constraints lawyers are bound by.

Let us turn to your article. You mention that for law firm valuations one needs to know the circumstances under which the valuation is conducted. Can you comment on that?

There is a definition of the term value, saying that a firm's value is what an informed buyer and informed seller, neither under undue pressure, will enter into a deal. Buyers and sellers usually have very different opinions on how much the firm is worth. Therefore one has to look at why the parties want to sell or buy and what is conveyed in the end. I often take a more limited view that something is worth what someone else is willing to pay for it. A deal happens if the buyer's range overlaps a seller's range. In the end, the buyer is interested in the profits on future revenue streams. But those are not guaranteed, whether or not clients will stay with the buyer depends on several factors. The tricky part of such a transition is to align the interests of all three groups – buyers, sellers and clients. Therefore law firm valuation is much more than just due diligence of financial statements, legal and business aspects.

However, in your writing you present several methods to value a law firm. What value would you recommend to base the valuation on in order to get the most reliable results?

An accrual basis valuation adjusting for the appropriate specifics of the situation and the market is best. However, revenue multiples are the easiest to understand and are often quoted. For professional services firms it basically is the sum of all collected professional services. Revenue is also the number with the lowest potential to be influenced by accounting assumptions and tax planning. However, remember that it is the profits of those revenues that are most important. It depends on the situation you are in. If you are a buyer you prefer to pay for the practice over time as you gain confidence that the practice does in fact transfer and to fund the acquisition out of the practice's cash flow. If you are a seller you prefer to get all cash up-front and not risk loss due to the buyer's actions. Finding a way to bring those seemingly irreconcilable positions into harmony is the art of structuring a deal. Here providing a mix of consideration – some cash up-front and some over time and to allow for adjustment of the deferred portion to reflect the success of the transfer may bring the parties together. The seller takes on some risk but could gain if the practice grows during the earn-out period. The buyer is protected by only paying for the practice that transfers, but gives up some of the immediate upside to growing the practice. It aligns the parties to work together to make the transition as seamless as possible for clients. For example, a seller who is still participating in the outcome is far more likely to pitch in when the client raises an issue only the seller has intimate knowledge of.

In your paper you mention the importance of the possibility to increase prices. Why, in your opinion, is it so important for a law firm to be able to increase its prices after a takeover and why would they not be able to do so?

There are three primary ways to grow as a firm. Option one is to grow with the market at its pace, adding lawyers and/or locations, option two is to increase one's market share and option three is to increase rates. As for now the market for private law firms is not growing. And the ease and pace of rate changes is not as robust as the market was prior to the great recession. Therefore, only option two is the primary growth option available for private law firms at this moment. And there are some complications. Rates are usually higher in bigger firms. So, if a firm is absorbed by a larger firm it might find itself in a surrounding where higher fees are the new standard. There are, however, restrictions in the Code of Ethics potentially preventing you from simply increasing the smaller firm's fee arrangements with clients. In addition, some clients seek so-called "most favored nation" agreements. Such an agreement entails that Client 1 will get the same conditions for service X as the client with the best terms. Therefore it is crucial for firms to understand the pricing the acquired clients are accustomed to, the ethical restrictions in play, its own fee arrangements and the ability to harmonize pricing over time in satisfaction of the first three conditions.

In recent years, some jurisdictions flattened the path to outside investments in law firms by introducing ABS or even going as far as allowing law firms to go public. In your article you guess that, if such a development will be taking place in the U.S., this might be a game changer for law firm valuation. Why is that?

First, it substantially increases the potential number of buyers (investors). However, it also means that some of the compensation previously earned by partners will now go to the investors. So too will some of the rights of governance and oversight. Even if firms float a minority interest to outside investors; it will still likely lead to significant change in how those law firms are structured and operated. But again, it depends on your position in the law firm during the deal. For an older partner close to retirement it would be interesting to go public, simply because it would allow them to more easily, and possibly at a higher price, liquidate their share in the firm. For younger partners, however, this would mean that a growing share of the overall profits will have to be paid to outside investors leaving

less income for themselves. And for a lawyer about to enter the partnership, it will likely increase the cost of their buy-in