

Exit strategy

Jeff Zindani discusses how to ensure the successful sale of a legal business, the questions to first ask yourself, and ways to ensure both the best price and a lasting legacy for your hard work



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Not a day goes by without news of a merger or acquisition hitting the headlines in the legal press. We know law firm sales take place all the time, yet it is still the case that the various exit options available to law firm owners are scarcely talked about.

From my experience, both as a lawyer and mergers and acquisition matchmaker in the legal sector, this remains a taboo subject, rather like discussing how much money you earn. Maybe it's a British thing, where talking about money is unseemly, particularly if law firm owners are 'cashing out'.

Even when I'm contacted by a firm looking to sell or merge, they tend to be circumspect and certainly not the assertive lawyers you might expect when it comes to spelling out what they want. Generally, there are many open questions and the impression given is that they have little idea about the exit options available. Law firm owners are likely to know more about the housing market and the processes for the sale of their home than of their firm.

So why does this matter? Well, without exit planning you are taking huge potential risks. What will become of your firm if anything happens to you? What if your situation changes? By not planning, you are making it far more difficult to obtain the full value of the firm, particularly if market conditions change.

Myths and biases

Perhaps the best way to understand the exit taboo is to get under the surface of why law firm owners fail to talk about it.

The insightful author and investor, Touraj Parang, in his piece "Why Founders Are Afraid to Talk About Exit Strategies" in the *Harvard Business Review* 2022, gives us clues around the myths and biases which are sometimes held by business owners, and in my experience apply equally to the legal sector ([tinyurl.com/yc2dajm7](https://www.tinyurl.com/yc2dajm7)).

Consider what he calls the "myth of acquisition failure". The legal press like a negative story – just read the *Law*

Society Gazette news pages and you'll see comments on why a merged firm has collapsed or talks have failed.

This has perpetuated what Parang sees as a false narrative and popular misconception that most acquisitions are likely to lead to failure. Of course, some mergers do fail, but the reality is that there are very few true mergers. Most are acquisitions dressed up as mergers like the Clyde & Co/BLM merger last year, which created an insurance services giant, known from day one as Clyde & Co.

The truth is that most acquisitions don't fail and the best way to ensure success is to make sure you plan well in advance.

Optimism bias

Another bias that plays out in the legal sector is what Parang calls "optimism bias".

Optimism fuels growth, but it can also give rise to a false sense of confidence and create strategic blind spots. For example, a boutique firm that only focuses on one or two practice areas is more susceptible to market changes affecting the firm. Without proper strategic plans in place, the firm may end up just muddling through when actually the time is perhaps right for them to exit.

An example of this was when the 2013 personal injury reforms were introduced, bringing about a significant challenge to road traffic claimant work. Many lawyers told me then that the reforms would have little impact and that there was no need to worry – it would all be okay. They were clearly overly optimistic.

Present bias

A curious bias I have seen in the legal sector is what Parang calls "present bias". He neatly sums this up as, "[i]n general, we tend to show a bias towards the present, prioritising near-term outcomes over long-term results and significantly discounting future risks and rewards".

Too often I have seen law firms with a partnership model paying out all their profits each year, with little planning for the future. They don't plan for a sale in

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the next few years because they have immediate issues and goals to tackle.

Succession taboo

“The sooner founders create an exit strategy and take steps to implement it, the higher will be their chances of a successful outcome if they ever need to sell their business,” according to Parang.

Linked to the exit taboo is the related reluctance to talk about succession. Many small and medium-sized law firm owners want to extract as much as possible from a sale but also want to leave as quickly as possible.

Here is the problem – why would a buyer pay anything if the key fee-earners and those close to the main clients have exited? It’s not unusual to see very profitable firms worth almost nothing because they have not got a succession plan in place.

It is difficult to know what is behind this, but it may be due to problems in getting the right talent or concerns about losing clients. Perhaps there is a more straightforward reason: senior partners have simply not thought about the strategy behind an exit, which will usually involve some succession planning. By the time they come to sell they are at a point where they are more than ready to leave or retire.

Law firm owners are not usually good at strategy, and although this may sound cynical, not having a strategy is too often the strategy. But this can easily be put right.

One way to pave the way to succession might be, for example, to have senior assistants or associates shadowing the senior partners before or during an exit period.

The longer the earn-out period (typically two to three years), the more confidence a buyer will have. Partners who want to leave within a few months will be seen as a red flag unless there are good reasons for doing so or they are not critical to the firm.

What’s the firm worth?

“Valuation that is not backed up by a story is both soulless and untrustworthy and we remember stories better than spreadsheets” – Professor Aswath Damodaran, *Narrative and Numbers: The Value of Stories in Business*.

It is quite remarkable how little law firm owners know about the value of their firms. Although they must wonder how much their firm is worth and have those conversations among themselves and with their accountants, there will also be

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those who will avoid considering this for the reasons discussed above.

So how do you determine the value of a law firm, given it is a ‘people’ business? There are countless valuation models that exist, the more sophisticated ones being applied to larger law firms.

A straightforward approach is to look at value based upon the cashflow that a buyer would expect it to generate from the practice over time. You may use an EBITDA (earnings before interest, taxes, depreciation and amortisation) formula and multiples of earnings to get to a more precise figure.

Overall, you need to look at the value drivers of the firm.

Some will say this is a waste of time as the price is only what a buyer will pay. This is utterly flawed as the firm must have a financial basis – let’s face it, we are not dealing with the sale of a Picasso.

However, demand may well drive up multiples, so market behaviour must be factored into any valuation. This will turn on specific market factors and in the legal sector that means specific practice areas that are in demand.

For example, there is currently a real premium for boutique practices or firms that have a subscription-based or recurring fee model, as well as high demand for large full-service law firms, who are seen by private equity houses as sound, eternally profitable businesses.

Great expectations

Valuation is difficult so beware of those who claim to know the price of a law firm with such a degree of certainty that it sounds scientific because it really is not.

As Oscar Wilde once said, “a cynic is someone who knows the price of everything and the value of nothing”. Remember, law firm valuations, like all business valuations, are usually wrong.

As such, law firm owner value

expectations can be tricky to manage.

There are those who have wildly ambitious expectations. Typically, with smaller firms, I have seen what some have coined ‘the Ikea effect’ at play, with certain law firm owners who believe that, as they have built the firm over a number of years, it is worth significantly more than it is worth in the market.

I have also seen the opposite, where law firms are real gems and yet have been advised to close the practice and pay run-off cover. Firms also forget that their story, their history and their people can be as valuable as the numbers which are crunched.

It is important to remember, you are not selling a house but a law firm which to a buyer is an income generating asset.

In the driving seat

There are many reasons why law firm owners rarely discuss exit and avoid thinking about the long term or what might happen to their firm should market conditions change.

Planning for succession, getting a better understanding of your firm’s value and putting a long-term strategy in place can be difficult amidst the day-to-day challenges and demands of managing a law firm, but proper consideration of exit options will pay off.

With simple exit planning, there is no need to press the panic button – you are in the driving seat and more likely to achieve better outcomes for your firm and its employees as well as realising the best price when the time comes.