



## Succession – a problem or an opportunity?

In the current legal market and COVID19, succession issues in many smaller to mid-size law firms are becoming urgent priorities needing to be fixed.

A long period of working from home, combined with higher pandemic-related PEP for many firms, has meant that many partners over the age of 60 have decided to retire rather than going back to the office grindstone. Some are joining new model law firms where there are no office overheads and they are paid a percentage of cash collected; some are becoming consultants rather than equity partners. Others perceive the future of the smaller firm to be under threat with rising PII, more regulation, and higher demands on risk management. Such firms are facing the prospect of the retirement of partners, some of whom may have been the driving forces behind their firms in the past, creating the dilemma of how to replace them (and their capital) to secure their futures. The dilemma can be even worse for sole practitioners who, when facing retirement, may have even fewer options.

Other law firms are not immune from the need to take steps to safeguard their longer term futures even though succession for them is not an immediate problem. These are firms which will need to grow in a focused manner if they are to provide greater expertise and have more financial and infrastructure resources to become more competitive.

How can these two types of firms, each with different issues, possibly provide a solution to resolve the other's issues?

### 1. Firms with succession issues

Succession planning is strategic and forward planning is the key to success, being driven by issues including:

- Age profile of partners
- Run-off issues
- Lack of career path planning
- The need to prevent loss of talent and key client relationships

- Economic pressures to reduce the size of the equity

Asking questions such as:

- Is our age / practice profile aligned?
- Are our practice areas future-proofed?
- What do we put in place of retiring partners?
- Do we know what our younger partners / senior associates want from their careers?

will serve to highlight issues relating to a firm's future.

Unfortunately, in some firms partners or sole principals sometimes seem to have put their heads in the sand and hope their succession issues will just go away. However, succession problems need to be resolved because they will not go away and will become more acute as time passes. **Forward planning really is the key to future proofing a law firm.**

How should a small firm or a sole practitioner approach dealing with succession?

Options may possibly include:

- Continue the practice by taking in new partners or handing over to one or more existing partners, if there are available candidates willing to continue the practice on an acceptable financial basis which accommodates both outgoing partners and new or continuing partners. However, greater aversion to taking on risk or lack of ambition these days on the part of some younger lawyers may mean that partners who would like to retire are finding that this option may not exist. The risks of investing are often perceived to be greater where a firm's clients are concentrated around a retiring partner or partners.
- For sole practitioners, close down the practice, with the costs of run – off cover associated with this route, which may make this option unattractive. For other sole practitioners who cannot afford to or choose not to, buy run – off cover, this may mean having to continue to work while running down their practices to a level of turnover which will make buying run – off cover more affordable.
- Finding another firm to sell to or to join as the realisation grows that the only sensible option may be to throw in their lot with another firm which has a need for profitable growth.

Examining the option of selling to employees using the tax-efficient Employee Ownership Trust (EOT), beginning to be used by professional services firms. An EOT is a special form of employee benefit trust introduced by the Government in September 2014 in an attempt to encourage more shareholders to set up a corporate structure similar to the John Lewis model. The aim is to facilitate wider employee-ownership, albeit via an indirect holding. For the equity partners, it allows them to claim a full UK capital gains tax exemption on the disposal, and evidence shows significant increases in employee engagement and productivity as a result of ownership.

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In this Briefing Note I will focus on the option of joining with another firm and looking at how this option might be successfully approached, but please contact us if you would like to discuss or explore the other options such as an EOT.

Smaller firms or sole practitioners with succession issues should ask themselves certain questions -

**Do I have a business which another firm is likely to want to acquire?**

Acquisitive firms are likely to be seeking to add to the existing skills and expertise they already have or to create new areas of expertise to fill gaps. Firms should therefore work at building competitive focuses to their practices which are going to be attractive to acquisitive firms. By their nature, sole practitioners and many small firms already have focused and profitable niche practices. In particular if a firm's practice is -

- in an area of expertise currently in demand and where there is likely to be sustainable growth in the future;
- which another firm needs but cannot itself provide or grow easily, quickly or at an acceptable economic cost; and
- which is delivering increasing profitability on a sustainable basis from a stable and growing client base,

then that firm is likely to be **an attractive target and may have something to sell.**

This is about ***picking winners*** and will require forward planning to ensure that a firm creates something which will have a value and may be sold. This is not a pipedream – there are many examples of smaller niche or boutique law firms which have realised their value by carefully preparing their businesses for sale in this way.

**On the other hand, smaller firms with a mixed bag of unfocused and not very profitable work are likely to struggle to find anyone to take them on.** If a firm is in this category, then it should take a hard look at itself to see how it can become more attractive to a potential acquirer –

- perhaps it has an area of work which serves no useful purpose and loses money or burns cash which the firm should close down or dispose of, to sharpen the firm's focus and make it more profitable and financially stable;
- if the profit trend is downwards and debt is increasing then more drastic measures are likely to be needed, not just to prepare the business for disposal but to enable it to survive and avoid a 'fire sale'.

- Clients have also used this approach to improve profitability to a level where independence is then sustainable. The question “what would I do if I were to acquire this firm?” is always a healthy one to ask.

### **Does my firm have a value?**

This question can often be approached by looking at what a lawyer may have to sell –

- His or her services / labour? – these will have a price / salary in the employment market;
- There may be some ‘hard’ assets such as work in progress or a property which can be realised;
- Or there may be an element of ‘goodwill’, which is the difference between the net hard asset value and what another firm is prepared to pay for the business.

**NB – in relation to valuation and to ensure you receive your value, always take good valuation advice from qualified experts.**

## **2. Firms seeking profitable growth**

These firms may identify that not only may they not have sufficient resources to achieve their ambitions, but they may also realistically recognise that *on their own* they are unlikely to be able to build such resources at an acceptable economic cost to their partners. ‘*Scale*’ is therefore required if a stronger resource platform is to be developed. Achieving this will enable a law firm to better:

- Grow its ability to attract, retain and develop the best people.
- Provide enhanced ability to exploit opportunities and to provide clients with the services they will need.
- Build a management support infrastructure and know how / expertise to underpin the provision of high quality legal services clients now require.
- Build a higher level of sustainable profitability than is currently being achieved
- Keep clients as they grow

### **How can a law firm build a stronger platform for focused growth?**

For a firm looking to expand by non-organic growth, there may be a number of internal obstacles to achieving what might be regarded as a 'merger' -

- They will only look at a target firm as it is now, rather than visualising what **together** the two firms could become;
- Many firms I speak with only wish to combine with a smaller firm (presumably for reasons of control);
- They only look at the differences between the two firms, rather than their **compatibility** and how they might 'mesh' together to create something greater than the individual parts.

An alternative to a 'merger strategy' is an **acquisition strategy** by which a firm will aim to acquire good clients, people and expertise from a number of small firms who may be looking for 'lifelines'. **A good place to start would be to identify firms which have succession issues.**

An acquisitive firm seeking opportunities should be clear as to its future business focus and identify target firms with a view to filling gaps or strengthening existing areas of work to enhance that business focus. Clients no longer want generalist law firms, but instead want to instruct firms which have clear specialisms appropriate to their needs.

### **Research the market**

Whether you are a 'buyer' or a 'seller' you will stand a better chance of finding what you are looking for if you thoroughly research the market and develop a clear strategy. A merger alone is not a strategy- it is a means to an end. A number of targets may need to be looked at and ideally an internal team should be put together which has the skills to effectively consider these matters. If not, then appropriate external help should be enlisted.

I find that even in small geographic legal markets, many firms do not really know much about the other firms in that location and the work they do. They often have 'perceptions' but rarely any hard knowledge or real quantified analysis about a firm and its business.

A firm may have drawn up a shortlist of target firms which it has researched, possibly using various criteria such as 'compatible cultures', reputation, strategic fit, market positioning or size. It may then have arranged a meeting with its No.1 target on the shortlist.

At that first meeting a firm is likely to have no longer than an hour to make an impact and to sufficiently enthuse and excite the target firm with the idea of joining it, so they will want to take the matter further and at least arrange a follow up meeting for more detailed discussions. To achieve this an acquirer firm will need to present a clear and compelling vision for the future.

However, a firm making an approach may well be asked some searching questions by the target firm. For example:

*"We can see what we could do for you, but what could you do for us?"*

*“[Sale / acquisition / merger] is not currently on our agenda, so why do you think getting together with you is something that would be of interest to us?”*

*“How will putting our two firms together make the resulting firm more profitable than we are currently?”*

**Carrying out in-depth research and analysis of the market and the target before meeting will always pay dividends and will enable a firm to give a clear message to the other party that it has done its homework and deserves to be given a hearing.**

As part of this process, it is important to look beyond what each firm now represents and instead, consider what the two firms together could build for themselves, and the potential benefits which could accrue to both parties. Developing and communicating these messages are some of the most important things that those running the two firms will need to undertake throughout discussions, as well as subsequently, to ensure *the deal* is not only concluded but is successfully implemented to achieve both parties' objectives.

Whether your firm is a potential buyer or seller, does it have a plan for its future?

We are experienced at supporting you in these complex and important decisions. Contact us if you would like to discuss.

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