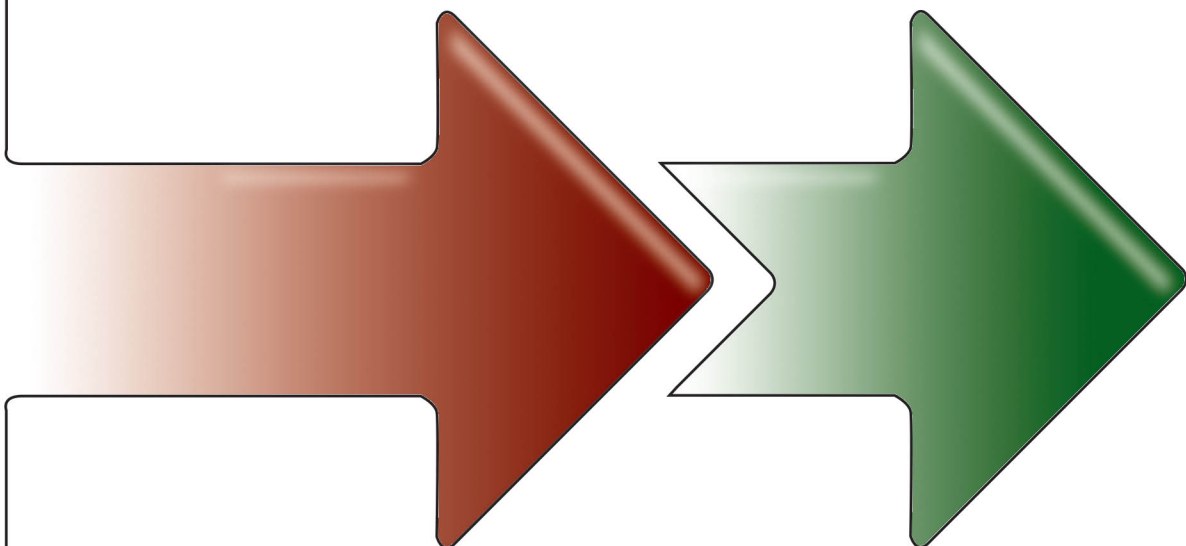


# Succession Planning for Solo and Small Firms and Rewards for Retiring Lawyers

## Presenters

*Arthur G. Greene*

Arthur G. Greene Consulting, Bedford, NH





## **Succession Planning for Solo and Small Firms and Rewards for Retiring Lawyers**

Are you a solo or a senior partner in a small law firm? If so, what is your exit strategy? Have you thought about it? Or, will you be one of those lawyers who continue working until the day you drop, largely because you haven't planned ahead? Some lawyers die at their desks, leaving the clean up to other lawyers or family members. Other lawyers wind down their practices and close the doors. But, there is another alternative that may be the best choice - that is to develop a succession plan under which you can retire gracefully on your own terms, while transitioning the law practice to a successor.

Any large firm that has survived the transition from its first generation of lawyers to the second generation understands the succession concept and has successfully navigated through that transition. Small firms, and particularly first generation firms, are the firms at risk of not surviving the retirement, disability or death of their founder or their senior partner.

Solos also face difficult issues. They are mostly lawyers who have found working alone suits them and the thought of working with a peer may not seem attractive. Solos also have to be remarkable lawyers in skill and flexibility, but fewer young lawyers may be attracted to the solo life. The question remains. What do they do at the end of their careers? Wind it down? Take in a younger partner? Try to sell the practice? In fact, there are more choices than many solos realize. Making the decision may be tough; but implementing the decision may seem formidable. Exit planning for many solos seems daunting and leads to inaction.

The key to succession planning is to recognize that it is a process, not an event. That process should begin five to ten years before the solo approaches retirement age. The decisions you make along the way will affect the value of the firm for purposes of transferring it to your successor(s). Identifying a successor and developing a step-by-step transition process

takes time. The succession plan will require the successor lawyer to develop leadership abilities, understand management responsibilities, and participate in an orderly plan for the transition of client relationships.

The goals of a succession plan should be (i) to make sure your clients on-going needs are well taken care of, (ii) to provide you with the flexibility you need to enjoy some personally rewarding retirement years, and (iii) to maximize the value you receive for the law practice you have built through many years of hard work. The goals are achievable, but only through a planning process. In most circumstances, age 70 is too late to successfully address the necessary planning. If you are in your mid-50s, now is the time. What are you waiting for?

## **SUCCESSION PLANNING FOR SOLO PRACTITIONERS**

Succession planning for the solo practitioner involves transitioning the practice to another lawyer or law firm. Unfortunately, many solos have worked alone for years and the thought of having another lawyer join in the practice does not resonate well when thinking of an exit strategy.

The solo practitioner has the following choices:

### **1. Wind Down and Close the Office**

If the solo has either not considered or has not accepted the possibility of a succession plan, the result will be an eventual closing of the law office. In many respects, this will be easier than grooming a successor; on the other hand, this approach will not capture any value for the retiring solo. The abrupt approach is for the solo to announce the closing of the office as of a given date, thereby providing all clients with the time for an orderly process in selecting a new lawyer to take over. The gradual approach is to stop taking new matters and go into a wind-down mode which involves completing most or all existing projects. A transactional lawyer can successfully wind down a practice in 3 to 6 months. A trial lawyer may be tied into existing cases for 2 or 3 years.

## **2. Recruit a Successor**

Some solos will want their law office to survive them and can engage in a process to hand pick a successor to whom they will entrust their clients' legal matters. The successor can be a younger lawyer to be groomed to become the owner of the business. After a few years, the new lawyer can be offered a partnership, which can be tied to an exit strategy with an appropriate compensation arrangement for the retiring solo. This succession approach requires a five to ten year process.

## **3. Merger**

The solo can merge with another solo or with a small law firm. This type of arrangement usually involves a two or three year exit strategy. Often the retiring solo is provided an Of Counsel arrangement with appropriate compensation. The Of Counsel duties may vary, but a critical component is continued involvement with the clients as matters are transitioned to different lawyers. Experience has shown that some continuing involvement of the retiring lawyer is critical to the new firm retaining the clients.

## **4. Acquisition by a Large Firm**

Solo practitioners with a high level practice and a strong client base can be attractive to some large firms. There have been numerous instances where large firm have brought in successful solo practitioners and offered a mutually advantageous exit strategy for the solo. It must be noted, however, that only a few solos have practices that would be attractive to a large firm.

## **5. Sale**

Law practices have not been the subject of straight sales until the recent adoption of Rule 1.17 of the Maine Rules of Professional Conduct. Prior to the adoption of Rule 1.17, indirect sales took place in law firms through internal arrangements requiring buy-in and pay-out as partners entered and departed from those firms. That indirect method allowed lawyers in firms to "sell" their practices, which put them in a different position than solo practitioners.

Theoretically, the adoption of Rule 1.17 provides solos similar opportunities to those held by lawyers in law firms. While the more traditional method of an internal transfer may still be preferable where that choice is available, Rule 1.17 now allows a straight sale to a third party.

Key provisions of Rule 1.17 include:

- Seller has to cease practicing law.  
See Professional Ethics Commission Opinion #210
- Written notice to the Seller's clients (and to the Board of Bar Overseers) and must include (i) the proposed sale, (ii) the client's right to retain other counsel, (iii) the fact that the client's consent will be assumed if he doesn't take any action within 90 days (Note: see rule of other details of required notice).
- The terms of any proposed change in the fee arrangement.

There are other conditions so it will be important to review the Rule in its entirety.

Given this array of possibilities, the solo needs to consider which choice best suits his or her needs in achieving identifiable personal goals. While a wind-down to close an office requires a lot of administrative detail work, it can be an easier road to follow than grooming a successor. Finding a successor or identifying the appropriate lawyer can be difficult. Not only are you concerned with legal competence and client service requirements, but shared values and work ethic become critical. You also need to recognize that no matter how careful the selection process, it may take a year or two before you know if you have struck the right match. Failure and the need to restart the process is always a possibility.

Here is the main point. Solo practitioners have choices, perhaps many choices. But the lack of planning causes most solo practitioners to approach their retirement age without having a plan, which will have the effect of reducing the choices available. Many solos close their doors because they failed to consider the alternatives in advance of their retirement age.

## **SUCCESSION PLANNING FOR SMALL FIRMS**

Many small law firms are first generation firms, led by their founders during their 20, 30 or 40 year existence. Clearly, the retirement of the founder challenges the continued existence of any small firm.

The small firm has many of the same choices that the solo practitioner has, but there is one important difference. In the small firm, the successor (or successors) may be lawyers who are already working in the firm. While that should make succession easy, most small firms do not plan and succession becomes hard to accomplish.

The founders of most successful small firms are both strong leaders and rainmakers. When they grow the firm, they tend to look for lawyers who can service clients that the founder has generated. Rarely, do they look for other lawyers with the same leadership and marketing skills that they possess. As a result, the other lawyers assume a supportive role and do not develop the skills necessary to successfully lead the firm.

Succession planning for a small firm involves:

- Making sure the ages of the firm's lawyers are balanced across more than one generation.
- Making hiring decisions based on the eventual future need for leaders and rainmakers.
- Educating all lawyers in the business of law; that is, how the financial model works and what is necessary to attract clients and make the firm financially successful.
- Looking for opportunities to involve all lawyers in some aspect of management, in order to evaluate whether they have the skills to be future leaders of the firm.
- Making sure the evaluation of the firm's lawyers includes contribution to the culture of the firm and its shared values, in order to reinforce the importance of those qualities in the future leaders of the firm.
- Developing a client transition plan which involves the next generation of lawyers participating with the firm's most important clients, while protecting the more senior lawyers on issues of compensation and status.

All of this takes time. The succession planning process starts with hiring decisions and continues with activities designed to train future leaders. Any firm with senior lawyers in their late 50s should be addressing succession planning.

Succession planning is based on an assumption that it is desirable for the law firm to grow and/or evolve from one generation of lawyers to the next. In a sense, succession planning institutionalizes the firm, which results in the health of the firm superseding the needs or desires of any partner. Decisions are made based on what is best for the firm, not what is best for any particular individual. Putting the firm first is truly a transformative process.

### **1. Creating Value**

One important factor to consider in any exit plan is how to maximize the value of the professional business you have created. Simply winding down a practice and closing the doors may satisfy a need to make an exit with no strings attached, but it will not maximize the monetary value you achieve in the exit process. In fact, the continuing expenses may exceed revenue in the final months. For lawyers who want to maximize monetary value, grooming a successor to continue the practice and transitioning clients over time is the best bet. An abrupt sale, as contemplated by Rule 1.17 of the Maine Rules of Professional Conduct, will be more challenging due to client retention issues.

### **2. Partnership Structure**

Regardless of whether your firm is a sole proprietorship, a partnership, a professional association, or a limited liability company, there are many ways to structure a succession plan. A two-tiered partnership can be incorporated into any ownership structure and it represents a good way to get a lawyer involved in some management issues and learn whether that lawyer has potential to be a future leader of the firm. It represents a good transitional step between associate and equity partner.



When it comes to structuring the exit plan, Of Counsel arrangements or consulting agreements are excellent vehicles for providing the retiring partner with a reduced role and appropriate compensation, based on a variety of factors which may include the value of the business being transitioned. Lawyers structuring such a deal have great flexibility. The entity structure should not stand in the way of creating innovative approaches for succession from one generation to the next.

### **3. Generational Spread of Partners**

Some aspects of succession planning are pretty simple. For example, as you grow your firm make sure you hire from different generations. You would be surprised to learn how many small firms grow by adding lawyers from the same generation as the founder and end up with all the partners in the same age group. It is not uncommon to have firms beginning to think about succession planning and realize that all the lawyers are in their 60s.

### **4. Leadership Requirements and Management Responsibilities**

Rarely do we see a successful firm without strong leadership, which makes leadership a critical succession planning issue. Some believe leaders are born, not developed. Others embrace the concept of leadership training for associates. We won't solve that debate, but the point to take away is that successful succession involves identifying or developing one or more effective leaders.

Management is unlike leadership and involves different skills. Every law firm needs individuals who are organized and have the ability to carry out policies and effectively implement new plans. The majority of the management duties can be delegated to an office manager or a senior secretary.

### **5. Entrepreneurial Spirit**

Solo practitioners or founders of small law firms are likely to have an entrepreneurial spirit. Without it, they would be out-of-business. Lawyers added to the firm may or may not have an entrepreneurial spirit. Too many small firms hire because there is a need to cover an existing

work load and not with the idea that they are choosing future partners. This common failure in the approach to recruiting not only discourages the best candidates, but tends to result in assembling associates who are looking for a job, not those with an entrepreneurial spirit, who are looking for an opportunity to own or lead a law firm. Small firms need to do a better job of recruiting future owners, providing partnership criteria information, and then assisting their associates with career plans.

## **6. Transitioning Clients**

Clients are not commodities that can be easily transferred from one lawyer to another. They cannot be transitioned like a mortgage from one bank to another, with little notice to the consumer. The lawyer/client relationship is intensely personal. The Rules of Professional Conduct require that it is always the client's choice as to the lawyer who will represent him or her.

All of this highlights the importance of an orderly transition of clients. For example, a client is less apt to exercise his or her right to move to a different lawyer if the senior lawyer introduces the client to his future successor years in advance of the senior lawyer's departure from the firm. In an ideal situation, both the senior lawyer and the successor lawyer both participate in the client's legal matters for two or three years, giving the client opportunity to develop a relationship with and confidence in the new lawyer. However, even in the best of circumstances, transitioning clients is a challenge. Most reasonably sophisticated clients know more than one lawyer in the community and while they may have been loyal over the years, the retirement of their lawyer provides an opportunity to switch to some other lawyer acquaintance in the community. Many firms have been surprised to find that, even with their best efforts, the retention of the clients of a retiring partner has been a challenge.

## **7. Control Issues**

There are other challenges associated with succession planning. One is control. The sole practitioner, or the founder of a small firm, may have been in control for several decades and at a senior age is inherently unable to give up control. The two-tier partnership structure is often a good solution for the founder who is not ready to give up control of his firm. Providing different ownership interests and weighted voting is another approach. Most senior lawyers find a way to make a transition work, rather than closing their office.

## **8. Compensation Issues**

Compensation is an issue closely associated with control. A proper succession plan requires the successful senior lawyer transitioning clients to younger lawyers three to five years prior to an anticipated retirement. This raises issues about partner compensation. Most small firm compensation systems would be structured in a way that would reduce the compensation of the senior lawyer who shares his clients with others. As one can imagine, in that scenario, the senior lawyer is not incentivized to share his or her clients, or to reveal retirement plans. While compensation is a major hurdle, there are a number of techniques that have been employed by innovative firms to protect the compensation of senior partners during such a transition.

## **VALUATION ISSUES**

Any second generation law firm has likely developed a process for admitting new partners and retiring senior partners. Some firms do not require payment for acquiring an ownership interest and are referred to as “free in, free out.” In other words, new partners are not required to pay for the purchase of an ownership interest and retiring partners do not receive payment for selling their share of the equity. In those cases, retiring partners receive a return of capital and any other retirement-type benefits are usually limited to funded pension plans.

Most law firms require new partners to pay for shares and retiring partners receive value for selling their ownership interest in the firm. Many firms are motivated by the desire to reward the founders and/or the current partners for the “sweat equity” involved in the developing,

growing or maintaining of a successful firm. In other cases, the firms simply want the new partners to feel invested in the firm and may set a modest price that is more symbolic than actually representing a valuation.

There is no easy answer to determining the value of a law firm or a law practice. There are too many variables, including the practical aspects of the circumstances of the potential successor (or buyer). Formulas are of no significant value. Some lawyers in small firms think their law practices are worth millions of dollars. They are usually wrong. Other lawyers think their law practices are worth nothing. They are usually wrong as well.

Many business appraisers do not understand how to value a law practice, nor do they understand the unique nature of a law practice. And, that factor is compounded by the lack of information in the marketplace on sales of law firms. There are relatively few straight sales and there is no database of comparable sales of law firms.

In attempting to create a realistic valuation, it is important to start with an understanding of what is being sold. Likely to be included are hard assets, work in process, receivables and good will (value of clients retained going forward), with a reduction for any debt. The value of the firm's client base is both the most important aspect and the most difficult to evaluate. The client retention possibility will depend on the nature of the practice and the extent to which they consider themselves firm clients, as opposed to clients of individual lawyers. In a sense, what is being sold is a network of contacts that represent nothing more than an opportunity to retain or acquire clients.

There are several approaches to valuation adopted by law firms. The method of valuation should always be included in the partnership agreement. Those methods include:

Arbitrary Valuation Process - For lack of a better approach, many small firms simply set an arbitrary price when transferring an interest in the firm between partners. Sometimes the amount to be charged is set out in the partnership agreement and other times it is set on an ad hoc basis when transactions occur. Although common, such an approach is not recommended. It lacks credibility and does not position the firm well for the long term.

Formula Technique - Some firms develop a common sense formula to value the firm that focuses on financial data, without applying sophisticated business valuation techniques. The value determined by the formula is then divided by the number of share or points outstanding to get a value for each share or point, for purposes of valuing any transfer.

Business Valuation Techniques – Some firms engage a business appraiser to determine the value of their firm for purpose of transitions. Some firms engage the appraiser one time and then create a formula for the future based on the appraisal. Other firms engage an appraiser each time there is a transition. Avoid appraisers with little or no experience valuing law firms for the purpose of transferring ownership interests. Only appraisers with a good understanding of the unique nature of law firms can properly develop a meaningful value.

At the end of the day, every potential arrangement must be considered a unique situation. An objective analysis does not provide the answer. Creativity is the key to developing a successful arrangement that will work for both the retiring lawyer and the successor.

### **EXIT PLANS FOR RETIRING LAWYERS**

A successful firm is the result of good decisions made by the partners and through many years of hard work. There were likely profits the partners could have taken out as compensation, but chose to leave in the firm to support its growth, largely to benefit the next generation of lawyers. As a result, fairness requires new partners to pay something for acquiring an ownership interest in the firm from those partners who are either retiring or reducing their ownership interest.

There are several types of rewards that can be considered for partners at the end of their careers. They may include one or more of the following:

- Return of capital,
- Payment for the sale of their ownership interest in the firm,
- Funded retirement benefits,
- Unfunded retirement benefits, and/or
- Compensation from *Of Counsel* arrangements.

The significance of this array of possibilities is that it is usually some combination of these aspects that result in a successful arrangement. Every situation is different. What might be suitable for one firm could be totally inappropriate for another.

One anomaly to have in mind is the small firm that is struggling and not providing a satisfactory level of compensation to its partners. Comments made by partners in those firms are “Who would want to be a partner in this firm?” Or, “Who would pay money to be an equity partner here?” In those circumstances, expecting an associate to buy an interest in the firm is unrealistic and having firm resources to reward retiring partners is probably out of the question. The solution, of course, is to make an effort to build partnership value.

Retirements can cause financial stress on any small firm, so careful analysis needs to be conducted before structuring exit plans and committing to payments to departing partners. Every lawyer owes it to themselves to explore the different types of rewards that can be provided to founders and other senior partners who have developed successful firms to transition to the firm’s next generation of lawyers.

## **CONCLUSION**

Succession planning involves several specific considerations, which every firm should address:

1. Making sure the ages of the firm’s lawyers are balanced across more than one generation.
2. Making hiring decisions based on the eventual future need for leaders and rainmakers.
3. Educating all lawyers in the business of law; that is, how the financial model works and what is necessary to attract clients and make the firm financially successful.
4. Looking for opportunities to involve all lawyers in some aspect of management, in order to evaluate whether they have the skills to be future leaders of the firm.
5. Making sure the evaluation of the firm’s lawyers includes contribution to the culture of the firm and its shared values, in order to reinforce the importance of those qualities in the future leaders of the firm.

6. Having a valuation process that can be employed to set a realistic value on the firm for purposes of supporting the transfer of ownership interests in connection with the plan for succession.
7. Developing a client transition plan which involves the next generation of lawyers participating with the firm's most important clients, while protecting the more senior lawyers on issues of compensation and status.

But back to the main point, which is that small firms and solos need to get beyond the day-to-day work and plan for the future. Make decisions about growing the firm and creating a firm identity. Address succession planning and have an exit strategy that will allow your clients to continue to be well represented and, at the same time, will permit you to retire gracefully, achieving rewards for the value of the firm you have created.

[illegible]



[illegible]

[illegible]