DEAL STRUCTURING ESSENTIALS

STRATEGIES FOR LAW FIRM TRANSACTIONS

TOM LENFESTEY

FOUNDER & CEO, ATTORNEY, CPA,
ACCREDITED BUSINESS INTERMEDIARY, BBP INDUSTRY EXPERT
IN LAW FIRMS

Book Confidential Call!

info@thelawpracticeexchange.com

Book Your 15 Minute Confidential Strategy Call Now

1. Complimentary strategy call to discuss your goals and how to achieve them
2. Discover the best path forward for you and your practice
3. Start your planning today by booking a call as your first step.

INTRODUCTION

When considering buying or selling a law firm, several deal structures are available, each with its own benefits tailored to different strategic goals. The most common arrangements include asset purchases, Of Counsel agreements, mergers, and joint ventures. Each of these options serves unique purposes depending on the needs of the transaction.

While asset purchases are common, other structures such as Of Counsel agreements are used when specific transactional goals call for them. Regardless of deal structure, buyers will typically desire sellers to hold equity or some financial incentive after closing to share risk and ensure that the seller is committed to the transfer of brand and other aspects for overall success of the deal.

Common Deal Structures

1.Asset Purchase: Outright Sale of Firm

An Asset Purchase is the most common deal structure among our clients. In this arrangement:

- **Deal Structure:** An outright sale of assets (including your personal and firm brands) to another attorney or law firm as a buyer to continue your firm under their ownership. May also be structured as equity sale where the total ownership of the firm is transferred to another.

- **Payment Structure:** Typically, you receive between 20% to 50% of the total consideration in cash at closing.

- **Earn-out Period:** The remainder is paid over an earn-out or performance-term time period, which could last from several months to over five years. This period allows the buyer to smoothly transfer the firm’s marketing, client relationships, management, and operations.

- **Transfer Success Factors:** The duration of the earn-out period post-closing can vary based on how easily the firm's management, operations, and client relationships can be transferred to the buyer. A firm with well-established processes and a strong marketing presence might see a shorter earn-out period and higher payment at closing due to easier transition.

2. Of Counsel Arrangements: A Succession Plan with Non-Equity Role

Of Counsel arrangements are popular for succession planning, where the seller joins the buyer's firm in a non-equity role but brings their client base:

- **Deal Structure:** An Of Counsel or other affiliation with a law firm where seller (and their team) will personally join the buyer's firm to continue the practice and transition clients and goodwill value over time with the support of buyer's resources until seller's determined retirement point.

- **Payment Structure:** The seller receives a robust compensation and benefits package for the firm's value, along with payments for legal work performed post-closing. Such arrangements typically include origination payments for a period of time to ensure value payout to the buyer, and may even include profit-sharing.

- **Earn-out Period:** The payments may be structured for a term of years commencing after joining and continue even upon retirement in some circumstances to assure firm value is paid. Innovative firms might offer the seller origination credit for a set number of years after retirement, allowing them to benefit from new client engagements during this period.

- **Transfer Success Factors:** The success of the arrangement often hinges on the ability to effectively cross-market to the buyer and seller's clients, and transition seller's client management to buyer's team.

3. Merger: Combination of Buyer and Seller’s Firms with Seller Ownership Exit

Mergers involve combining two law firm entities to continue the seller’s services while providing financial incentives for the seller’s eventual exit:

- **Deal Structure:** A merger or joinder by seller’s firm with buyer’s firm to continue seller’s services and provides seller a financial exit or retirement incentive for when retirement is desired.
- **Payment Structure:** Sellers may receive all cash, a combination of cash and shares from the post-merger entity, or a complete share swap with financial payment to be made to seller’s ownership at a later date, or upon retirement.
- **Earn-out Period:** Post-merger earn-out could occur years later depending on the seller's desired retirement date, but typically will be paid to the seller over a 3–5-year period once triggered.
- **Transfer Success Factors:** This structure typically aims for a complete integration of the two merging entities, creating a single, more robust organization. Transfer success improves with good overall fit between the firms -, their cultures, billing practices, client mixes, etc.

4. **Joint Venture: Co-Counsel or Other Structure to Keep Both Buyer and Seller Firms in Place**

Joint Ventures are formed when both parties aim to limit risk sharing to the specific venture rather than the entire business:

- **Deal Structure:** Two law firms may enter a joint venture with a test phase, followed by a full merger or acquisition based on success.. These can also be structured as separate entities or subsidiaries, depending on the strategic goals (entering new market, new litigation, team sharing, etc.)

- **Payment Structure:** Payment structures would vary based on overall deal but would incorporate one of the payment structures noted above upon an exit or retirement of a party after a full integration has occurred.

- **Earn-out Period:** Varies, but typically 3-5 years post exit.

- **Transfer Success Factors:** Ideal for exploring new markets or services with shared risk and investment, and success created from aligned business interests, partnership potential, and overall firm integration.

Common Payment Structures

The payment terms with each deal structure can also vary widely from transaction to transaction. Payment terms depend on the firm's characteristics and transfer risk. Higher risks result in less cash upfront and more performance-based payments. The greater the risk, the less cash at closing and more variable the payment structure after closing. The lesser the risk of transfer, the more cash at closing v. earnout or other performance payments. At the end of this report are two examples illustrating this concept and how deal structure and payment terms work together.

Most deals involve an initial cash payment of 20% to 50% of the total consideration, with the remainder paid through performance-based structures such as earnouts or seller financing. The earn-out period can last from several months to five years, depending on how easily the firm's operations and clients are transferred to the buyer. Another important factor is the seller's effective transfer of clients and goodwill to the new owner. Firms that have effective marketing programs that regularly generate new clients by quantifiable amounts based on the level of marketing investment, rather than clients developed through the seller's personal relationships, will generally see shorter payment periods, greater down payment amounts and other favorable terms. All else equal, a seller with exceptional processes and procedures will be able to transfer management and operations to a new owner in an abbreviated timeframe with less disruption and hence shorter payment periods.

There are a host of ways in which the post-closing payments are structured. These structures depend on, among other things: tax considerations of both buyer and seller, the likelihood of the deal's success, ensuring that the deal cash flows for buyer, and deal financing. The post-closing payment structure will reflect appropriate risk apportionment between buyer and seller. Below you will find some of the more common structures used by our clients:

- **Guaranteed Payment.** Guaranteed payments at regular intervals throughout the earn-out period. The seller does not share the deal's risk with the buyer but also forgoes extra rewards if the deal outperforms expectations.

- **Seller-Financed Deal**. Seller receives interest payments in addition to the negotiated guaranteed earn-out payments. These can be fixed or have a variable component in the event revenues decrease below a certain level.

- **Remainder Equity Interest.** The buyer does not initially purchase all the equity of the firm. Seller typically has an obligation to sell a portion of the remaining equity to buyer at regular intervals over an agreed upon time horizon.

- **Pure Performance Based Earnout.** Little or no initial cash down. No payment guarantees. Firm performance must exceed a financial metric benchmark at regular intervals throughout the earn-out period for the buyer to receive a payment at the end of any given performance interval.

- **Performance-Based Earn-out with Upside.** Like the pure performance-based earn out, firm performance must exceed a financial metric benchmark at regular intervals throughout the earn-out period for the buyer to receive a payment at the end of a performance interval. However, the buyer is entitled to an enhanced payment if firm performance exceeds a second financial metric benchmark. In this deal, the seller may receive more than the expected purchase price of the firm.

- **Accordion Guaranteed Performance-based Earnout.** Like the pure performance-based earn-out, firm performance must exceed a financial metric benchmark at regular intervals throughout the earn-out period for the buyer to receive a payment. Like the performance-based earn-out with upside, the buyer is entitled to an enhanced payment if firm performance exceeds a second financial metric benchmark. However, instead of the seller being able to realize more from the sale than the expected purchase price, the length of the earn out period is adjusted up or down based on firm performance. That is, if the seller is not entitled to a payment at the conclusion of any given performance interval, the earn-out period is lengthened so that the seller has an opportunity to earn the payment for performance in an additional interval. If the seller is entitled to an enhanced payment, the envisioned earn out period is shortened. Seller will receive the agreed upon purchase price for the firm but the length of the earn out is variable.

- **Hybrid.** Earn-outs that mix any combination of the above are hybrid.

Again, earn-outs are structured in such a way as to appropriately apportion deal risk. All else equal, the riskier the deal, the more likely the earn-out will be tied to performance. Note that a seller’s premature exit from their business on sale will significantly reduce purchase price as the exit heightens deal success risk. Solo practitioners with clients tied to them should expect a deal in the form of an Of Counsel arrangement, or a performance based earn-out in an asset purchase deal. Larger multi-practice firms should expect any of the above earn outs.

Book Confidential Call!

info@thelawpracticeexchange.com

Book Your 15 Minute Confidential Strategy Call Now

1. **Complimentary strategy call to discuss your goals and how to achieve them**
2. **Discover the best path forward for you and your practice**
3. **Start your planning today by booking a call as your first step.**

The Best Deal Structure for You or Your Firm

The right deal structure depends on your firm's characteristics, your goals for the transaction, and how you envision your post-deal role. To navigate these complex choices effectively, consulting with experts who understand the nuances of law firm transactions is crucial. This guidance can help you select the most advantageous structure for your circumstances, ensuring a smooth transition and successful outcome.

What type of structure is best for you or your firm? Below are four examples that illustrate different scenarios. Consult with one of our experts to better understand what type of deal you or your firm would likely be offered.

EXAMPLE 1: Solo Owned Estate Planning Firm

Low Down Payment with Earn-Out

Background:

- **Practice:** Firm A is an estate planning firm whose owner has developed its client base through community involvement, including church groups and social events, serving both middle-income and wealthy clients.. Firm A's owner is versed in GRATs, SLATs, and the other alphabet soup of high-net-worth ("HNW") planning tools.
- **Client & Marketing:** Firm A's owner has developed her client base through her church group, the local Rotary club, the local country club, town hall meetings, and community social events.
- **Team:** Firm A's owner relies on two paralegals – one focused on simple wills, the other focused on HNW planning. Both have been employed by the firm for over 25 years and are nearing retirement.
- **Systems:** Firm A has weak processes and procedures in place, and Firm A has just begun the process of moving from a primarily paper-based working environment to an electronic one.

Hence, to run Firm A, its new owner must transfer client relationships that have been tethered to the current owner for decades, must ingratiate themselves in the local community as well as groups that the current owner is a member of, must be able to handle sophisticated HNW planning (requiring years of legal experience), and must identify talent that can take on the responsibilities of the firm's paralegals.

Potential Sale Structure:

- **Of Counsel and/or Merger with Another Firm:** Firm A's owner may look to join another firm as Of Counsel or merge her firm into another firm which also focuses on estate planning as part of her sale and succession. In doing so, she can hopefully assist in transitioning her clients and referral sources to other trusted attorneys in the new firm and obtain some needed resources from experienced paralegals and associate attorneys. The new firm may also have an attorney on staff to move into Firm A's office location and continue service in that community.

- **Asset Sale to Individual Attorney or Small Boutique Firm:** Firm A's owner may also consider selling her firm to an estate planning solo attorney looking for ownership or an estate planning firm seeking to expand its geographic presence into Firm A's market. This has some added challenges based on paralegal needs, and may require a longer transition.

Potential Payment Terms:

Under either scenario Firm A's owner will have a lengthy earn-out period, one that will likely last three or more years because of the transition difficulties, poor systematization and marketing overly reliant on Firm A owner. Under an Asset Sale, Firm A's owner may see a small down payment, but even that is unlikely given most marketplace buyers would be concerned with the transition risk of referral sources so tied to Firm A's owner. It is likely that the offer may be a full performance earn-out.

For example:

- **Purchase Price/Payment Terms:** 15% of Gross Revenues for 3 or more years. Gross Revenues would be tracked by the buyer based on clients or referral sources Firm A and Firm A's owner, and pay such amounts on a quarterly basis.

- **Transition by Firm A Owner:** Firm A's owner would also agree to stay on for a longer transition period to aid in the client and referral source transition - potentially for 12-24 months. During that time, Firm A's owner may be paid wages for legal administrative work, but would not be paid for the transition work required to transfer the firm's value to another owner.

EXAMPLE 2: Solo Owned Personal Injury Firm

Significant Down Payment with Some Earnout

Background:

- **Practice:** Firm B, a personal injury firm in a metropolitan area which has been in business for 30 plus years, has a revolving case inventory of 1,000 active personal injury cases.

- **Client & Marketing:** Firm B relies heavily on external marketing, using billboards, radio, and digital ads to attract clients. It can scale its client base by increasing marketing spend, with measurable results.

- **Team:** Firm B uses very few attorneys (if any other than the owner), and relies heavily on paralegals and non-attorney staff to handle most of the firm's work. Firm B's owner sits entirely in an owner's seat and no longer handles legal production.

- **Systems:** Firm B has processes and procedures in place to quantify lead generation and conversion. Firm B refers all matters that will be litigated out to other firms, and focuses only on revenue generation through settlement.

Hence, to run Firm B, its new owner will be focused on firm management, team integration, and brand transition, but need not fill other roles or nurture outside personal referral relationships.

Potential Sale Structure:

- **Asset Sale to Individual Attorney, Investor or Personal Injury Firm:** Firm B's owner may consider selling her firm to another individual attorney, an investor-attorney, or another firm looking for ownership or geographic expansion through acquisition. An individual buyer has the option to immediately step into an ownership and management seat benefiting from the firm's systematization, marketing platform, and team. The law firm buyer could purchase and leverage the existing brand, immediately gain market share, and reduce overall costs through operational consolidation.

Potential Payment Terms:

Under these scenarios Firm B's owner will have an abbreviated earn-out period – likely twelve months or less because Firm A runs like a machine, more akin to a service industry corporation than a traditional law firm.

- **Purchase Price/Payment Terms:** Likely to be millions down at closing with a smaller percentage of 20-30% of total purchase price tied to escrow or earn-out tied to performance over a 12–24 month post-sale period to ensure future intake mirrors historic intake.

- **Transition by Firm B Owner:** Firm B’s owner would also be required to stay on for far less time than Firm A’s owner - likely 12 months or less of part-time facilitation of management and team migration and culture integration. Firm B’s owner may also receive compensation for this work.

When buying or selling a law firm, the choice of deal structure plays a critical role in achieving the strategic goals of the transaction. Get the support and guidance you need to make this decision and so much more with a Preparing to Sell or Preparing to Buy Strategy Session with The Law Practice Exchange.

Whether opting for asset purchases, Of Counsel agreements, mergers, or joint ventures, each approach has distinct advantages depending on the needs of the parties involved. Ultimately, ensuring that sellers retain equity or financial incentives post-closing can help align interests and contribute to the successful transfer of the firm's brand and long-term success.

Book Confidential Call!

info@thelawpracticeexchange.com

Book Your 15 Minute Confidential Strategy Call Now

1. Complimentary strategy call to discuss your goals and how to achieve them
2. Discover the best path forward for you and your practice
3. Start your planning today by booking a call as your first step.