

Law Practice Transitions



Buying, Selling or Transferring a Solo or Small Firm Practice

November 1, 2013
Oregon State Bar, Tigard
2.0 General MCLE Credits

3:00-3:15 p.m.

Introducing Law Practice Transitions

Travis Prestwich, OSB Board of Governors, Salem

3:15-5:00 p.m.

Introducing Law Practice Transitions

- Is a Solo or Small Practice Worth Selling or Buying?
- The Team Approach to Transition Planning
- Transition Specifics

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Is a Solo or Small Practice Worth Selling or Buying

November 1, 2013

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IS A SOLO OR SMALL PRACTICE WORTH SELLING OR BUYING?

A. Seller's Perspective. One thing is certain about your practice. Sooner or later you *will* leave it. Your departure may be planned or unplanned. And the reason you leave may be anticipated (such as retirement) or unanticipated (such as a debilitating illness or death). My goal is to remind you that you can choose how to exit your law practice and encourage you to exit your practice with clear intention about why, when and how.

1. Exit Options: Close, Leave, Sell or Gift

a. Close.

The planned closure of your practice is a valid option for a sole practitioner. In this scenario, you decide when you want to close your practice and implement a plan to do so. Your plan will include what happens to your clients, files and staff. You walk away knowing you served your clients well and left no one in the lurch.

The unplanned closure of your practice is your default if you are a sole practitioner without an exit strategy. One day your doors will close unexpectedly because you are no longer able to practice due to your own illness, external circumstances (such as the illness of loved one), or your death. You (if you are able) or your staff or loved ones (if you are not) will have the unpleasant task of wrapping up your practice on short notice and without the benefit of your knowledge and guidance.

b. Leave.

The planned retirement or departure from a partnership is a valid option for a partner. Like the sole practitioner who chooses to close the doors, you plan

your withdrawal or retirement from your practice, including what happens to your clients, files and support staff. Your shareholder, partnership or operating agreement should specify what happens in the event of your departure, including if and how you will be compensated for your share of the practice.

Your unplanned departure is your default if you become ill or die. Your partners and staff will take up the slack and take over your practice – assuming you practice in the same area of law. If not, your partners will scramble to hire your replacement or refer your cases. The value of your interest in the practice will be substantially less due to your unexpected departure.

c. Sell. Selling your practice to a partner, employee or third party provides the best option for recouping some of your investment of time and money in your practice. This is also the option that requires the most advance planning.

d. Gift. Gifting a law practice is common among attorney family members who practice together (such as a parent to a child or sibling to sibling). This strategy is also an option for a solo practitioner who wants to transfer, without compensation, his practice to a valued associate. Like a sale, this option requires advance planning, especially tax and estate planning.

B. Buyer's Perspective. Starting a law practice takes more time and energy than finding an existing firm. Which choice is right for you depends on whether you have the time, money and expertise to create a practice that reflects your values and interests versus whether you can find a practice to join or purchase that is the right fit.

1. Starting a Practice. These are some of the many reasons that attorneys will start a practice:

- Can't find a job
- Want independence in selecting what types of cases to take and/or to practice in a particular way (style or philosophy)
- Want flexibility (time)
- Want to be master of own destiny (philosophical and financial)
- Moved by the entrepreneurial spirit
- It seemed like a good idea at the time ...

2. Entering an Existing Practice. Attorneys may enter an existing practice in these ways:

- Join a practice as an employee
- Join a practice as an owner or on an ownership track
- Buy a practice

C. Components of a Law Practice. What makes a law practice a viable business that can be sold depends on whether the practice will continue after the current owner's departure. These are the components of a law practice:

1. Documented systems and procedures. A system is a set of interacting or interdependent components forming an integrated whole. A law office has two systems: the legal system and the administrative system. Within each system are forms and procedures. For example, in a bankruptcy practice will likely have procedures for screening, client intake, preparing and filing forms, court appearances, and completing a

bankruptcy case. If different types of bankruptcy are handled, there will likely be different procedures for the different types of bankruptcy cases. Together these procedures form the bankruptcy system for the office. In contrast, the administrative system addresses the flow of work and money, human resources and general office management. Procedures will include everything from processing mail and bank deposits to leave requests. Most firms have processes and procedures for many if not most of their systems, but they are often not documented. Documented systems and procedures are essential to ensuring continuity when a firm changes hands. An office can run without the owner if the legal and administrative systems are well documented. The best way to know if this is true for a business is to determine whether the owner can go on vacation without needing to call the office.

2. Trained Staff. Documented systems and procedures do you no good if staff are not trained to use them. Staff are considered “trained” if they:

- Know how to do their jobs without the owner’s daily instruction
- Are empowered to do their jobs without owner interference
- Are capable of resolving issues without the owner’s constant guidance

The test here is whether the owner can go on vacation and know that almost anything that comes up will be handled competently without owner involvement.

3. Suitable Equipment, Software and Other Tools. A firm with outmoded or nonexistent equipment, software or other tools is probably not operating as efficiently as it could be. Look for equipment, software and tools such as forms and checklists that function well and save staff time.

4. Established Client Base and/or Marketing Strategy. A firm's clients come from an established client base (including referrals from that established client base), a marketing strategy, or some combination of the two. These factors will help evaluate the strength of a client base or marketing strategy:

- Percentage of repeat clients
- Percentage of client referrals
- Marketing history (how have marketing funds been used)
- Marketing plan and budget (is there a plan and a budget or is marketing done randomly?)
- Are the seller and key staff actively engaged in marketing?

5. Pristine Financials. Financials are the key to understanding a firm's profitability and value. Financials are pristine if:

- All income is reported (including barter income)
- Income is accurately broken down by area of practice where appropriate
- Expenses are legitimate
- Expenses are properly categorized
- Profit and Loss Statement shows a healthy income and owner salary for at least 3 years
- Balance sheet shows positive equity (there are some exceptions)

6. Clearly-Understood Intangibles. Intangibles such as good will, a particular practice area, or unique clients can add value to a practice but they are hard to

value. They can add greater value if they can be quantified in some way. For example, say that a portion of a general practice involves disability work in a geographic area where no one else is handling disability. If the disability work can be quantified in dollars and as a percent of the practice over time, that might suggest a more stable practice than a firm without the disability work because no one else in the area is handling disability.

D. Which Option is Right for You? As you ponder what to do with your practice, you have two broad choices: do nothing or plan. If you do nothing, the defaults mentioned above will kick in. If you don't like the default option, then you must plan.

1. Sellers. Gifting your practice requires some planning but takes the least amount of effort on your part. You gift your interest and the recipient is responsible for assuming your practice. Choosing to close your doors or leave your firm is a valid choice and takes a moderate amount of planning and effort to ensure your clients and staff are provided for. The most time-consuming and costly option is selling your practice, but it also provides greater opportunity for return on your investment in addition to the compensation you have received over the years.

2. Buyers. Starting a law practice requires a significant investment of time, energy and money: time in learning how to run a business, energy in working long hours to hone both your legal and business skills, and money for the initial investment in equipment, software, office space, marketing, and staffing a law office. Then there's your time spent developing systems and procedures. Many attorneys will admit they had no idea what they were doing when they started their practice or how much time and

money it would take to create a thriving practice. Even those who have a clue found they spent long hours on administrative duties rather than practicing law. Buying a practice is a viable alternative to doing it the hard way. You will still spend time, energy and money completing your due diligence, but that investment will be far less than starting a practice from scratch.

The Team Approach to Transition Planning

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THE TEAM APPROACH TO TRANSITION PLANNING

A. Transition Planning. Transition Planning is the process of identifying:

- **which** method you will utilize (close, leave, gift, sell)
- **when** that will be accomplished
- **how** that will be accomplished

If you would like to gift or sell, you will also consider:

- **why** you want someone to take over your practice
- **who** will succeed you
- **what** that will look like and what role you will have (if any) after the transfer

B. Emergency Plan. An emergency plan is for the unexpected event such as a serious illness, accident or death that prevents you or a key staff member from working in the practice. Topics covered in this plan include:

- Who has authority to make legal decisions
- Who has authority to make business decisions, including financial decisions
- Who will cover the workload of the key person
- What happens if the key person cannot return to work (sale, hire additional staff, close)

C. Collaborative Team

Getting clear about the value of your practice now and the components that go into that value will enable you to determine how much effort you will need to ready your practice for sale. In most cases, taking the time to improve areas that need work will enhance the value of a practice and make it easier to sell. The team approach to transition

planning relies on a variety of professionals to help you plan and implement your transition. You may need to consult with several of these individuals who should work collaboratively with one another as needed to help guide you through the transition.

Your collaborative team might include:

- 1. Accountant.** Your accountant may know your firm's financials but is not responsible for knowing whether they are accurate unless you request an audit. Your accountant can and should spot trouble issues, however, and can advise you how to correct these issues. In addition, your accountant can analyze the impact of a sale or gift over time versus an outright sale or gift.

- 2. Banker.** Your financials are used to calculate ratios and analyze whether your practice is a good credit risk. If you are not familiar with how ratios are used to estimate the financial strength of a practice, talk with your banker.

- 3. Bookkeeper.** To accurately value your practice, all income and expenses must be properly charged to the correct accounts and your balance sheet must accurately reflect assets, liabilities and equity. If your firm's bookkeeping has been sloppy, you will want to hire a forensic bookkeeper to clean up your books. Your CPA may be able to help with or oversee this process.

- 4. Business Consultant.** Have a business consultant review your operations, especially staffing, processes, and procedures. A practice with established staff and documented procedures is worth more than one with no procedures and high turnover. To ready your practice for sale, you may need to spend time, energy and money developing and/or documenting your firm's systems and procedures. A consultant can

also help with a variety of employee relations issues, such as evaluating key staff who are potential buyers, working with staff to build core competencies, addressing problem employees, and preparing staff for a sale.

5. Business Valuation Expert. Once you have solid financials and documented procedures, hire a business valuation expert (often a CPA, business consultant or business broker who handles professional business valuations) to value your practice. There are multiple ways to value a professional business. Ask which method is appropriate for your particular business. Consider getting a second opinion so you can develop a value range.

6. Financial Advisor. Work with a financial advisor to determine how much you will need in retirement and to help you analyze seller financing options.

D. Selling a Practice

1. Preparing to Sell. Your first step is to identify *who* you want to sell to.

Some options include:

- Sell to someone who currently works in your practice
- Bring someone in with the intent of having that person buy your practice
- Sell to a stranger

There are pros and cons associated with each of these options. Some considerations include:

a. Competency. The competency of your successor dictates whether the practice will succeed after you are gone. Ask yourself whether a buyer is competent to run the practice or has the interest and ability to gain the competency to do so.

b. Relationships. How will the buyer interact with your staff after the purchase? Relationship dynamics can kill a well-intentioned enterprise. Choose your successor wisely.

c. Finances. You will want to ask yourself these questions: What are your financial needs and goals? What are the financial resources of the buyer?

2. Sell it yourself. Selling your practice yourself generally means you have (or find) someone to buy your practice. The obvious buyer is an existing employee. You can also hire an attorney with the intent to have that person buy your practice or market your practice for sale to an outsider. Avoid making assumptions that an existing or new employee will want to purchase your practice. Many attorneys are comfortable working for other people and don't want the responsibility that goes with running a practice. Communication is critical for all up front if you intend to have an existing or new employee buy you out. Don't overlook a larger firm with an office in another city as a possible buyer or a firm in your own community that wants to expand its practice to the area of law in which you practice.

3. Work with a Business Broker. A business broker will identify potential buyers and market your practice for you for a commission on the sale. A good broker will also guide you in getting your practice ready for sale, selecting the right buyer, negotiating the price and terms, and completing the transaction.

E. Buying a Practice. Before you decide to look for a practice to buy, it's best to have an idea what you are looking for. If you are not sure, you can shop around and consider different options, but you'll save considerable time and effort if you identify what you want before you starting looking.

1. Identifying what you want. These are the big-picture decisions you'll want to make up front:

- Specific practice area(s)
- Solo or small firm
- Geographic location
- Potential for market expansion

2. Finding potential sellers. Sellers can be found in a number of ways, including:

- Online job boards, including OSB's
- Work with a business broker
- Identify attorneys by practice area through local bar association, web sites, Martindale-Hubbell and similar publications
- Advertise in state and/or local bar journals

3. Due Diligence. A part of your due diligence, you will want to ensure you review these documents:

- Financials for 5 years, including profit and loss statement (detail), balance sheet, federal and state tax returns, accounts payable, accounts receivable, and budget

- Contracts
- Leases
- Client lists (consistent with bar rules)
- Bar complaints, claims and litigation
- Insurance Policies
- Bank records, especially Client Trust Account
- Policy and Procedures Manuals

Expect to be asked to sign a confidentiality agreement. A seller may ask you to sign a purchase and sale agreement before allowing you to review all of the above records, but you will want to see certain records such as financials before taking that step. See if you can negotiate review of just some of these documents before signing a purchase and sale agreement. Otherwise, you will need to ensure your purchase and sale agreement includes a sufficiently-long contingency period to allow you to complete your due diligence.

4. Red Flags. Remember that caveat emptor applies to the purchase of a law practice. Here are some things to watch for:

- Promises of future ownership with nothing in writing
- Seller will not share financials or other key documentation
- Seller's financials indicate seller is or was behind in taxes on more than one occasion
- Staff who seem unhappy or disgruntled
- Bar complaints

- Pending claims against the firm
- Large accounts receivable

F. Who Values a Practice? There are no general standards for valuing any business and indeed there are many ways to value a professional practice. The value will depend on how self-sustaining the practice will be when the current owner disengages from the practice. Parties to a purchase and sale agreement can agree on a value. Valuations are typically provided by a business broker, CPA, business consultant, but may also be performed by an attorney or economist. Ask what valuation method will be used and why that is appropriate for your practice. If you believe a specific valuation method would be appropriate for the practice, be sure to discuss this before the valuation is commenced to ensure the valuator agrees with and is willing to use that method.

Transition Planning Details

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TRANSITION PLANNING DETAILS

A. Components of a Transition Plan. Your transition plan is a three-step process: intend, plan and implement.

1. Intend. Before you can plan, you need to be clear about your goal (your desired outcome) and why you want that particular goal. Some possible goals:

- Provide financially for yourself and your family
- Ensure your practice continues
- Provide employment for family members and staff
- Leave a legacy

2. Plan. As you ponder which option is right for you, first consider *when* you want to exit your practice. Eight to ten years from your targeted retirement date is the ideal time to start planning. Your options become fewer and the work becomes more intense the longer you put off planning. If you are less than three years from your targeted date, you need to take action immediately. Your transition plan is your roadmap to get you from Point A (today) to Point D (the date you disengage from your business). Your plan includes these components:

- Your stated goal
- How you will achieve that goal (big picture as well as details)
- Who will assist you with your transition (your “transition team”)
- Timeline for implementing your plan
- When you expect to complete your transition

3. Implement. Do not underestimate the importance of having a transition team to include at least your bookkeeper, accountant, office manager and business consultant. Your team will help you stay focused and hold you accountable to your goal.

B. The Buy-Sell Arrangement. As attorneys, we know that solid agreements are critical to ensuring a smooth transaction. If you do not practice business law, hire an attorney to help you with your agreements.

1. Buy In Over Time. There are many ways to structure a sale or gift to an employee or family member including:

- a compensation agreement that provides for a minority interest in the business as part of compensation
- provision in Will that gifts of an interest to a key employee or family member in the event of your unexpected death or provides an option to purchase
- purchase and sale agreement that provides for a payroll deduction to be applied toward the purchase price

Keep in mind that income received over time is taxable to the owner, so consult with your accountant before you enter into such an agreement. Be cautious in gifting an interest that you can't easily get back if there is a parting of the ways. For example, you don't want to have to buy back stock that you gifted so ensure you have a way to get the stock back. Also, the business interest should be subject to an automatic reversion if the employee chooses to leave the firm within a period of years. Every practice is unique.

While there are some contract provisions that should be included in every agreement, your agreement should be custom-tailored to your situation.

2. Outright Sale.

a. Sale of Business versus Sale of Assets. Most small business sales these days are sales of assets rather than the business itself to protect the buyer from pre-sale liability, especially for taxes. Sales of professional practices, however, will more likely be a sale of the business than an asset sale. You will need to demonstrate that the business is current on tax obligations and free from actual or known potential lawsuits. Depending on the nature of your practice, you may be asked to retain pre-sale liability. A sole proprietor may want to be organized as either an S corp or PLLC for ease of sale.

b. Purchase and Sale Agreement. You will need a Purchase and Sale Agreement with an earnest money deposit. Typical contingencies will include 1) inspection of the business financials, tax returns, books and records, 2) business appraisal indicating a value equal to or greater than the purchase price, and 3) financing. If possible, agree in advance who will do the business appraisal to avoid surprises.

3. Financing. Ideally, you will get your money up front but few young attorneys have sufficient cash to simply buy your business. If they did, they would probably start their own practices. It's likely some kind of financing will be needed.

a. Bank Financing. One of the reasons to have your financial statements in pristine condition is because your buyer will need to use those financials to obtain financing. If your financials reveal problems, your buyer will simply not be able

to get financing and you will be left with either owner financing or finding alternative ways to finance the purchase.

b. Owner Financing. Consider owner financing only as a last resort and only then if a) you are leaving the firm on solid financial ground, and 2) you have a great deal of confidence in the buyer's ability to both assume responsibility for your clients and also manage the firm. Otherwise, you are taking a substantial risk that you will get nothing. Remember, your firm's success after you are gone depends on the competency of your successor. If you do choose to provide owner financing, you will want a Security Agreement with the buyer that pledges all assets, including accounts receivable, to you until you are paid in full. You will also want to record a UCC Financing Statement (UCC-1) (which functions like a mortgage or lien) to create a security interest in the assets and accounts receivable.

C. Staying on Board: Of Counsel and Other Options. Your transition can include a period of time when you continue to work in the firm or maintain an of counsel relationship with the firm. Some options include:

- continuing as a minority owner for a period of time (at agreed compensation)
- Providing training or consulting (paid or included in the purchase price)
- Maintaining an "of counsel" (non-owner) relationship with the firm (be sure to consult and follow any related rules of professional conduct).

If you want to stay on for a while, be sure to negotiate the terms in advance and document in the purchase and sale agreement or separate agreement executed at the time of sale.

MCLE FORM 1: Recordkeeping Form (Do Not Return This Form to the Bar)

Instructions:

Pursuant to MCLE Rule 7.2, every active member shall maintain records of participation in **accredited** CLE activities. You may wish to use this form to record your CLE activities, attaching it to a copy of the program brochure or other information regarding the CLE activity.

Do not return this form to the Oregon State Bar. This is to be retained in your own MCLE file.

Name:		Bar Number:	
Sponsor of CLE Activity:			
Title of CLE Activity:			
Date:		Location:	
<input type="checkbox"/> <i>Activity has been accredited by the Oregon State Bar for the following credit:</i>	<input type="checkbox"/> Full Credit. <i>I attended the entire program and the total of authorized credits are:</i>	<input type="checkbox"/> Partial Credit. <i>I attended _____ hours of the program and am entitled to the following credits*:</i>	
____ General	____ General	____ General	
____ Prof Resp-Ethics	____ Prof Resp-Ethics	____ Prof Resp-Ethics	
____ Access to Justice	____ Access to Justice	____ Access to Justice	
____ Child Abuse Rep.	____ Child Abuse Rep.	____ Child Abuse Rep.	
____ Practical Skills	____ Practical Skills	____ Practical Skills	
____ Pers. Management Assistance	____ Pers. Management Assistance	____ Pers. Management Assistance	

*Credit Calculation:

One (1) MCLE credit may be claimed for each sixty (60) minutes of actual participation. Do not include registration, introductions, business meetings and programs less than 30 minutes. MCLE credits may not be claimed for any activity that has not been accredited by the MCLE Administrator. If the program has not been accredited by the MCLE Administrator, you must submit a Group CLE Activity Accreditation application (See MCLE Form 2.)

Caveat:

If the actual program length is less than the credit hours approved, Bar members are responsible for making the appropriate adjustments in their compliance reports. Adjustments must also be made for late arrival, early departure or other periods of absence or non-participation.