

BUYING AND SELLING A LEGAL PRACTICE

The acceleration of change in the legal sector and the explicit objective of the Legal Services Commission (LSC) to contract with fewer, larger organisations, has made many practitioners re-consider where they want to be in three years time. For those that wish to get bigger, growth can be achieved in different ways although purchasing a practice is probably the most direct route for rapid expansion. Many practitioners, at various times, must have also considered the possibility of selling their practice. Both options present a number of hurdles and challenges.

Valuation

At the outset, serious consideration must be given as to the degree to which external events affect the value of a practice. Recently, the uncertainty surrounding the Carter Report has led most potential buyers of legally aided practices to be wary of buying all but the cheapest of practices. However, following publication of the report, it is likely that many will now try to achieve the best possible price for their firm.

Goodwill

When valuing a firm, several factors are taken into account. Amongst the most important is goodwill. Goodwill can be defined as the value of a business over and above the value of the assets of the business. Many see 'goodwill' as the price paid for purchasing a 'good name'. The tricky bit is valuing goodwill. Most valuations start with a multiple of gross annual recurring fees. Typically, the last three years earnings (preferably prepared by an accountant) will provide a guide as to what a purchaser could expect to earn in the future. As a starting point a multiple of between 0.75 and 1.25 of

annual fees is not untypical. The profitability of the practice will of course have a strong bearing on the actual multiple used. After all, a purchaser will have to work so much harder on making a poorly performing practice provide an acceptable return. It is also advisable to base the goodwill payable on actual fees achieved, especially if the payment terms have been agreed over a number of years. This can be reviewed at the end of each year during the purchase period and the total goodwill reduced if the fee targets are not achieved.

Staff

A prospective purchaser will want to estimate what is likely to happen to turnover in the first three years of trading following purchase. Much of this will depend upon the quality of the practice and what arrangements are in place to retain key staff. Purchasers of practices will be interested in knowing whether there are any contractual restrictions on staff preventing them from taking clients with them. Both buyers and sellers must consider the effects of The Transfer of Undertakings regulations (Protection of Employment act 1981) (T.U.P.E). The regulations provide that the seller may not dismiss staff to make the practice more attractive to a purchaser. Similarly, a purchaser may not arbitrarily make redundant staff that has been acquired as a result of purchase. Further, the purchaser is required by the Act to provide seamless employment to acquired staff on conditions that are no worse than they previously enjoyed.

Audit Record

Historically, audit record with the LSC

has not played a significant factor in establishing the price paid unless of course there is a prospect of the seller's contract being terminated. However, the new Peer Review audit directly measures the quality of the advice being provided by the existing practice. Buyers will be not be attracted to those practices who have failed to achieve a Category 2 rating and may have to pay a premium for a Category 1 rating. This is because the L S C has made it clear that they wish to contract only with Category 1 & 2 firms in the future.

Due Diligence

It is cumbersome but the disclosure and inspection of financial records is essential in order to avoid getting things badly wrong. There was a recent instance of a medium sized legal aid practice where checks about the firm's audit record and its contract with the LSC were being carried out. The firm that was being sold was almost wholly dependent on funding from the LSC. Unfortunately, after fairly basic investigation had taken place, it transpired that the purchaser had received a second consecutive 'Category 3' rating. This meant that the LSC would shortly be seeking to terminate the seller's contract effectively making the practice worthless. Unfortunately for the purchaser, 50% of the agreed six figure sum had already been paid. The seller left the country shortly afterwards.

Payment Arrangements

The purchase of a legal practice tends to be made in instalments depending upon the purchase price agreed. It is not untypical to agree to pay a third on the date that the agreement becomes effective, a further third 12 months after the agreement date and a final

third 24 months after the agreement date.

Conclusion

Buying or selling a legal practice is not an easy task. The seller must work hard to present the practice in its best possible light and be ready to answer all the questions that a buyer might ask. The buyer must be thorough and ask the right questions before making a commitment to go through with the purchase. As with all major decisions, appropriate legal, financial and taxation advice should be sought at the earliest possible stage.

This newsletter has been produced in association with DG Legal who provide specialist advice, assistance and support to legal practices.

Contact Details

**Brian Carruthers
Managing Partner
Thomas May & Co
Allen House
Newarke Street
Leicester
LE1 5SG**

Tel: 0116 233 5959

Email: briancarruthers@thomasmay.co.uk

Contact Details

**David Gilmore
DG Legal
Debdale Hill House
Debdale Hill
Old Dalby
Leicestershire
LE14 3LF**

Tel: 01664 822492

Email: david@dlegal.co.uk

Disclaimer – for information of users

This bulletin is produced for information only and no action should be taken without seeking the appropriate advice. Therefore no responsibility for loss occasioned by any person acting or refraining from action as a result of the material contained in this bulletin can be accepted by the authors or the firm.