Succession Planning for Small Law Firm Owners: The Associate Buyout

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Looking ahead to retirement? Sometimes the answer is already close at hand

Small firm owners planning ahead for retirement would do well to consider whether any of the firm's current associates could fit into their succession planning. This article dispels some common concerns about that approach and suggests a three-stage process for exploring and executing an internal succession plan.

If you are a small law firm owner in your 50s or 60s, the time to plan for your retirement is now. One of the biggest decisions you must make is succession planning—who will step into your shoes once you leave?

The lowest hanging fruit for you may be an attorney currently working for you. After all, an associate buyout accomplishes three of your main goals:

- Ensures your clients continue to receive good service
- Preserves your legacy
- Enhances your retirement nest egg

Yet pursuing the associate-buyout option is easier said than done. First, you need to make sure the successor lawyer has the "right stuff." After all, one doesn't want to turn over the reins to someone who, instead of

preserving a legacy, destroys it. Further, even with the right candidate, how do you structure such a transition to make the numbers work? That is, how do you arrive at a fair price and fair terms?

Before moving forward with an associate buyout, it's important to face and dispel a couple of fears you may have.

COMPENSATION

One of the most misunderstood consequences of adding a new partner is compensation. Many owners wrongly assume that once you make someone a partial equity owner, the new partner automatically participates in the firm's profits based upon ownership percentage.

You can simply let this fear go. Why? Big Wall Street partnerships don't automatically share profits based on ownership percentages. You don't need to, either.

Compensation decisions remain completely within your discretion as a majority owner. Thus, in the early years of a buy-out, when you typically remain the majority owner, fundamental changes to the new junior partner's compensation are unnecessary.

GOVERNANCE

The same principle that applies to compensation also holds true for firm governance. Only when the successor lawyer owns a majority of the firm can he or she call the shots. Of course, in most situations, the hope is that you and your successor will collaborate on major decisions, irrespective of control.

IS THIS THE RIGHT SUCCESSOR?

Hiring a great "worker bee" attorney hardly ensures you are also hiring a great attorney owner. Being a successful owner requires a skill set entirely different from that of a good working attorney.

As a senior owner, you must consider the following about your potential successor:

- **Do they have good business judgment?** Among other things, will the successor keep expenses low, screen clients effectively, get bills out in timely fashion, pursue collections diligently, etc.?
- **Do they have marketing sense?** Does the successor understand that the phone doesn't ring just because one practices law well? As you already know, the phone rings only when others (potential clients and referral sources) *know* that you are a good lawyer. Getting the word out requires business development skills. Does your potential successor have them?

Your answers to these questions will likely fall within one of the following:

- Are you kidding? Not on your life! And it isn't even worth trying to teach them.
- I'm reasonably confident that, with enough training and mentoring, my successor can get to where they need to be to achieve success.

If your answer is close to the first, there is no need to think any more about an insider deal. Many insider deals are partially funded from the firm's future profits in order to make it feasible for successors to pay the retiring lawyer. There will be no future profits for funding if the successor mismanages the firm. Time for Plan B—whatever that might be.

If your answer is much closer to the second, it is time to consider next steps.

CREATE A MULTI-PHASE, MULTI-YEAR SUCCESSION PLAN

A multi-phase, multi-year scheme works best for most associate buyouts. The phases, explained in the hypothetical below, can vary in length depending upon the full timing of your wind-down strategy.

Additionally, a multi-year approach offers two main benefits:

- First, buy-in obligations are more manageable when there is more time to make payments.
- necond, a successor's mental shift from employee to owner (along with the increased responsibilities) does not happen overnight. The adjustment often takes years.

The total timeframe can range from one to 15 or so years. Take this hypothetical as an example of the items to address and steps to take during a multi-year succession.

Assume a 56-year-old sole owner wants to transition the firm to one associate. The retiring lawyer seeks to completely retire at 65. This provides for a nine-year succession plan.

In general, there are three main phases in a successful transition. In this situation, each phase can last three years. Negotiations occur on a discrete phase-by-phase basis: Negotiations for each subsequent phase begin only after successful completion of the prior phase.

PHASE ONE (YEARS 1-3)

This phase is more or less a probationary period. It gives the owner time to evaluate whether the new partner does, in fact, have the "right stuff."

The associate starts to buy in at the outset. The cost is modest, as well as the ownership percentage the new partner receives. The owner begins to transfer some management responsibilities and to provide any necessary training and mentoring.

If this does not go according to plan and either the owner or new partner want to back out, the financial consequences for both parties will be minor. With a minimal buy-in during Phase One, buying out the new owner will similarly be minimal.

So what is the initial price of admission to become a minority partner? You will not find the answer in any bean-counter formula. Instead, focus on what the successor can realistically afford. Most successors probably won't have personal bank accounts with large balances. Additionally, traditional bank loans are rarely available. Most banks won't go near a law firm buy-in because they view them as too risky.

What most successors can afford is going without bonuses or a bump in salary during Phase One. This option is often affordable for the new partner, and should not affect cash flow or lifestyle too much. Many successors will balk at any proposed deal that requires a significant up-front financial sacrifice.

As for the ownership percentage to sell to the successor, there is no magic number. Once again, keep the number modest. A few percentage points are usually all that is necessary. Practically speaking, there is no difference between being a five-, 15- or 25-percent owner. In all three instances, the successor lawyer cannot overrule the majority owner regarding any significant management issues. Further, these three instances do

not impact the successor's compensation since, as noted earlier, ownership percentage does not affect compensation.

PHASE TWO (YEARS 4-6)

By now, the owner is gaining confidence that the new partner has the "right stuff" and the deal proceeds. During Phase Two, the ownership percentage of the successor starts to creep closer to 50 percent, but never actually reaches it. The buy-in amount also increases. Note, however, this is still usually not the time to create huge financial sacrifices for the successor. That will come in Phase Three.

PHASE THREE (YEARS 7-9)

Phase Three is the tipping point. The retiring partner loses majority status and, with it, legal and practical control of the law firm. Retiring owners can now envision their firm successfully moving forward without them; many begin to work part-time when this phase begins. Successor lawyers can now foresee a firm that is completely their own.

This is the time for payments to increase substantially. These three years of the buyout overshadow the earlier sums and are the key financial terms of an insider deal.

FINALIZE THE NUMBERS TO COMPLETE THE DEAL

There is no plug-in formula to determine the firm's value. Anecdotally, parties often arrive at a figure that seems "fair."

"Fair" may seem way too ill-defined a way to reach a deal. But the marketplace itself can help the parties come up with their own definition of "fair" and prevent both parties from overplaying their hands.

For example, senior lawyers should realize that if they ask for too much, the buyer will start to make completely new calculations. For example, how much will it cost to start a new firm as compared to pursuing the buyout? Insiders certainly realize the advantages of staying in place, but also recognize those advantages are only worth so much. In short, buyers will compare the risk and associated costs of hanging out their own shingle to the known cost of buying in.

On the other side of the table, the successor lawyer can't try to steal the firm away from the senior lawyer. Should the junior lawyer offer too little, most senior lawyers will still have the time to sell the practice to another lawyer or law firm and obtain a higher price.

In other words, the marketplace prevents the selling and buying lawyers from being too greedy. Accordingly, level-headed minds should be able to reach a fair price and reasonable terms.

There is often concern over whether successor owners can afford the substantial increase in buy-in amounts. As an initial matter, the successor is presumably now making more money. Unlike during the early phases of the transition, most of the firm's profits are now going directly to the successor. Additionally, negotiations can include extending payments beyond the term of Phase Three, thereby making yearly amounts more affordable.

OTHER CONSIDERATIONS

Timing, cost, and compensation are not the only major considerations that you will face when pursuing an associate buyout.

TAXES

Your law firm's accountant may not be of much help in determining your firm's value for a buyout. But your accountant is critical to ensuring that both you and your successor fully understand the tax consequences as the deal reaches completion. Do not proceed with any deal without their advice.

FIRM NAME

It is usually best to change your law firm's name by adding the junior name sooner rather than later. Even doing so during Phase One is not necessarily too early, since changing the name actually benefits both parties.

The senior lawyer's name presumably has attained a considerable amount of goodwill. The successor wants to ride the coattails of the retiring lawyer's name so that the marketplace can begin to recognize the association of the names. Further, it will be significantly easier for successors to create their own goodwill when their name is attached to an already well-known brand (the senior lawyer's goodwill). And the sooner the successor attains goodwill in the market, the more likely the successor will be able to maintain the firm's book of business.

CONCLUSION

If you are considering retirement in the near future, and you have lawyers working under you, an associate buyout is potentially an excellent exit strategy. It rewards the loyalty of a dedicated associate, puts cash in your pocket, and provides uninterrupted service to your clients.

Before you move forward, however, you need to ensure your associate is the best fit for your firm, and then be sure to allow enough time to make a smooth transition. This will provide you the time you need to adjust to a life of retirement and for your associate to adjust to the life of a law firm owner.

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