[FEATURE]

Valuation Considerations for Law Firms and Personal Injury Practices

BY LOUISE POOLE & RON MARTINDALE

Over the last five years to 2018, law firms in Canada have experienced solid growth with revenues expanding by approximately 4% and industry revenue totaling $25.5 billion. Overall, revenue growth is expected to continue over the next five years to 2023. However, industry growth has slowed because of technology developments, the availability of online legal tools, and a growing preference of large corporations to pursue legal issues through in-house counsel rather than using external legal counsel. Profit margins are also being squeezed, primarily because wage growth is outpacing revenue growth. The shifting legal landscape has many lawyers asking about the value of their firm or practice.[1]

When considering the value of a law firm, several qualitative factors may be considered:

- Size and number of clients;
- Nature of the clients – recurring or non-recurring;
- Transferability of client relationships;
- Fee arrangements with clients (contingent, fixed fee, etc.);
- Quality and experience of personnel (other lawyers and staff);
- Competition in the region;
- Location of the practice;
- Size of the firm;
- Firm infrastructure and systems; and
- Reputation and brand name recognition of the firm.

Although valuation rules of thumb may not be used as a primary valuation method by a Chartered Business Valuator ("CBV"), they are sometimes useful and interesting to buyers and sellers. A few rules of thumb for law firms are 3.5x earning before interest and tax ("EBIT"), 3.5x earnings before interest, tax, depreciation and amortization ("EBITDA") or 90-100% of annual fee revenue.[2] When using rules of thumb, great care should be given to assess the qualitative matters discussed

above and whether or not the rules of thumb are applicable in each instance. Such rules of thumb might apply to large corporate practices with recurring relationships that could be transitioned to a new lawyer.

An example of the types of firms commanding a higher goodwill figure are firms that practice wills and estate matters. A firm with a considerable number of wills in place is more likely to provide a more definite future income stream for the purchasing lawyer, therefore reducing risk.

Personal Goodwill

Another key component of law firm valuation is the issue of personal goodwill. Often the value of a law practice is based on the lawyer's ability to attract, service, and retain clients. Each lawyer has his or her own set of experience, knowledge, and reputation to attract clients, which cannot be transferred to another lawyer – this is often referred to as personal goodwill. Personal goodwill resides with the individual, is not transferable, and has little or no commercial value. The issue is whether clients are coming to a firm or to the individual lawyer for service.

Firms with significant personal goodwill may wish to find ways to institutionalize their firms to enhance the commercially-transferrable goodwill component. An example of this is ensuring that each client has more than one point of contact within the firm.

Personal Injury ("PI") Law Firm Valuation Issues

We comment specifically on valuation issues related to PI firms as the nature of the work and fee arrangements make for some unique valuation considerations.

PI lawyers assist individuals who are going through life-altering events – motor vehicle accidents, slips and falls, medical malpractice and other serious

Often the value of a law practice is based on the lawyer's ability to attract, service, and retain clients.

accidents. PI law firms are structured such that the value of the firm is different than the valuation of other types of law practices.

Of the total $25.5 billion in legal services revenue in 2018, approximately 20.8% of the industry revenue relates to civil negligence, personal injury, and criminal law practices.[3]

Often, the arrangement between a client and the PI lawyer is one of a contingent fee arrangement, by which the PI lawyer only receives payment if the client is successful with his or her case. Typically, contingent fees are approximately 30% of damages. This type of fee arrangement makes a PI firm difficult to value as there is great variability and unpredictability in the future cash flows.

A business or firm typically has the following components of value:

- Net tangible assets;
- Goodwill and identifiable intangible assets; and
- Redundant assets.

A PI firm is no different, except that a value must be placed on the contingent fees and the cases that are in progress.

Placing a value on contingent fees and cases in progress is a complex and detailed process, which involves many considerations such as:

- the likely outcome of the case;
- whether or not discoveries have taken place;
- an estimate of the amount of fees to be earned;
- whether the case will be settled or litigated;
- historical success rate of the firm;
- the likelihood of meeting the verbal threshold for pain and suffering;
- the likelihood of exceeding the statutory deductible where applicable;
- any costs or overhead associated with completing the work; and
- the timing of the resolution of the case.

Without a crystal ball, valuing the contingent fees can be a difficult task; however the use of history and industry statistics can assist.

In theory, once the contingent fees relating to the cases in progress have been estimated, the results can be present valued at an appropriate risk-based discount rate at the valuation date, to determine an overall value of the contingent fees from the cases in progress.

Usually PI firm purchasers do not wish to take on the risk of paying for cases in progress up front and often an agreement is made to split the fees, when earned, on the basis of the percentage of work completed at the time of the sale of the law firm. Such agreements require an objective method to determine the percentage of completion. Methods include reviewing milestones (for example, have discoveries been completed) or are time based (for instance, files settled within a certain number of months equates to a certain percentage).

Other important drivers of value in PI firms include the nature of the intake system used to assess case validity, and the use of artificial intelligence in such systems.

Why Does Value Matter?

A law firm's value affects almost every aspect of estate and succession planning such as retirement, estate/tax planning, life insurance and purchase and sale agreements. Without an idea of the value of your law firm, it may be challenging to make informed decisions and good future plans.

A CBV can help you determine the fair market value of your law firm to bring you peace of mind and assist with planning for your well-earned retirement or the exciting growth ahead in your career.

Louise Poole *is a Senior Manager of Advisory Services with Davis Martindale LLP*

Ron Martindale *is a Partner at Davis Martindale LLP*

NOTES

[1] IBISWorld Industry Report. (2018). 54111CA *Law Firms in Canada.*

[2] Business Brokerage Press (2018). *2018 Business Reference Guide: The Essential Guide to Pricing Businesses and Franchises.*

[3] IBISWorld Industry Report. (2018). 54111CA *Law Firms in Canada.*