Goodwill Hunting

Are law firms starting to acquire a value?

By Nick Jarrett-Kerr

Are law firms starting to acquire a value? A whole generation of law firm partners — those born in the baby boom just after the Second World War — is now reaching retirement age and forms the first generation for which the issue of goodwill has never been explicitly relevant.

Goodwill disappeared from the accounts and thinking of most law firm during the late 1960's when an earlier generation of partners allowed this intangible asset (for which they had usually paid on entering partnership) to be written off or commuted into annuities and retirement payments. There was also often an implicit understanding — particularly in the lockstep environment then prevalent in Europe — that partners, as they reached the retirement zone, would be allowed to retain high levels of compensation while at the same time easing off in their work efforts.

The profession became used to a "naked in, naked out" system which benefited the income terms of partners while they remained partners but allowed for no capital gain in relation to the value of the firm except in the case of freehold properties.

This short-term income philosophy still prevails in many firms. There are, however, some signs that the fixed capital tradition of partnership is coming under increasing strain, and not just because of the flotations of a couple of Australian law firms and the imminent prospect of external finance through the *Legal Services Act* in the UK.

For some years, there has been a modest trading activity in small practices and those of retiring sole practitioners, and this activity is scaling up in some areas of work. In addition, divorce and death has sometimes given rise to the need for some form of valuation in cases where the issue of goodwill has not been appropriately addressed in the partnership deed. On the whole, however, valuations have usually been informally reached and have included earn-out payments and recognition for the acquiring firm taking on professional indemnity liabilities as a successor firm.

The difficulty is that it is far from straightforward to value law firms — in common with other areas of professional services. This is largely because law firms are driven by people and not products, and by intangible resources and not tangible capital. Additionally, mandates from clients to law firm tends to be more episodic than consistently and sustainably repetitive.

This does not make law firms less valuable than businesses in other areas, but it does mean both that the valuation issues require a specialist approach and — perhaps more importantly — that potential purchasers may remain hard to tempt.

Some law firms will certainly get traded for value, but what is also likely is that incoming partners will become increasingly unwilling to invest their capital and future in a law firm unless they are sure of a proper return on their capital. We may yet see goodwill reappearing in law firm accounts.

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