Professional services firms: how to sell your practice

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We explore the issues to consider if you decide to close down or sell your practice, how to maximise the sales price, and how to cover yourself against liabilities.

Key Points

What is the issue?

The demand for buying and selling professional services firms is high, driven by factors such as competitive market pressures, increased regulation, professional indemnity insurance issues, and recruitment challenges. Many businesses are consolidating, and both buyers and sellers must address various practical issues.

What does it mean for me?

Planning for a sale should ideally begin three to five years in advance. This includes consulting experts, assessing business processes, restructuring if necessary, and obtaining a business valuation. Identifying potential buyers and addressing any business issues are also crucial steps.

What can I take away?

Owners should consider practical points when selling or closing a business, such as the need for run-off cover to protect against claims after closure. Earn-out arrangements can be part of the sale, where additional compensation is based on the business's future performance.

The appetite for buying and selling professional services firms at present is high. This may be being driven by a combination of factors:

- the overheads of running a business in an increasingly competitive market, leading to a need to consolidate;
- increased regulation, particularly in the audit arena;
- professional indemnity insurance issues; and
- difficulties in recruiting staff, leading to the need to outsource, often overseas, which causes further complexities.

What is clear, in my experience, is that more and more businesses are consolidating. And whether you are the buyer or seller of a professional services firm, there are a variety of practical issues that must be identified and addressed.

In the first of two articles, we consider the points to consider if you are selling a professional services firm, alongside the legal and accountancy advice that should also be obtained. In the second article, we will address the issues involved in buying a professional services firm.

Reasons to sell

One of the most common reasons behind the decision to sell a firm is when the owner is coming up for retirement or has other reasons, such as ill health or family issues, for wishing to exit the business.

Even if the owner is not yet ready to retire, they may be alive to the fact that there is no obvious successor to the business. This is particularly common in small firms and owner-managed businesses, where the owner has been significantly influential and has been reluctant to ‘let go of the reins’. (This maybe a good time to suggest that firms without a succession planning strategy in place should consider the role that junior partners are currently playing, and whether they can be given more opportunities to build the practice.)

Where the owner does have obvious successors within the firm to whom they wish to sell in the future, they may well, of course, be keen to maximise the sale price before the transfer of ownership.

Increasingly, though, it can be difficult for some firms to remain profitable, as a result of the issues identified above. The owners may simply recognise that the business needs to consolidate but is not large enough itself to purchase another business; in this situation, they will need to find a buyer.

In some less positive situations, the owner of the business may lose their licence to practise as a result of regulatory action. Reputational damage as a result of asignificant claim and the resulting harm might also mean that the business is unlikely to survive on its own. In my experience, these cases are reassuringly rare.

Hopefully, a decision does not need to be made in an emergency situation and there is time to prepare for the resulting sale.

When to start the process

As will become apparent from this article, to maximise the chances of the best outcome from a sale requires takes time and planning. It would not be unreasonable to start thinking about the issues involved three to five years in advance of the likely sale.

The intended seller should also start speaking to a range of experts who can assist in preparing the business for sale. This might include assessing the processes used in the business and making any necessary repairs, restructuring the business if required, and speaking to professional indemnity brokers.

Owners should call in a professional to conduct a business valuation in order to have a realistic idea of what price might be achieved on the sale. They may also assist the owner to review the market in order to identify likely candidates who might be interested in purchasing the business once all ‘wrinkles’ have been ironed out.

Issues to consider when disposing the firm

There are a number of practical points that should be borne in mind when selling or closing a business, but which are too often overlooked.

Closing down your firm

I often hear exhausted and disenchanted business owners saying that they will just close down their business and walk away. They overlook the need for run-off cover and the not insubstantial costs that might involve. They also overlook the exposure that might arise on them personally (whether they are a sole trader or a director in a limited company) if a claim is made against the firm outside the run-off period. It isn’t as simple as just ‘walking away’.

An honest and thorough review of the firm’s exposure to potential claims over at least the last six or seven years should be undertaken before the firm is closed down. This will allow the owner to be aware of potential exposures faced and to make an informed decision about the extent of run-off cover that must be purchased before the firm is closed down.

The cost of run-off cover will be determined by the firm’s contract with its insurer but is usually based upon the previous year’s premium. A well-run business with strong risk management and a good claims history is more likely to attract lower premiums, which means that any run-off cover purchased will be cheaper.

See ***Run-off cover*** for further details.

Run-off cover

Run-off cover is a form of professional indemnity insurance that applies when a business stops trading, goes into administration or an individual has retired. It can apply to businesses, partnerships, limited liability partnerships and unincorporated

companies.

Run-off cover will apply to claims that are made after the business has ceased and professional indemnity insurance cover has ended, but which relate to work carried out before that date. It will apply to both the cost of defending the claims and the claims themselves. If a claim is brought after a business has ended where there is no run-off cover in place, then the owner of that business may face personal exposure.

Generally, the insurance premium in the first year after trading is similar to that for the last year of trading, as that is when the risk of a claim being made is at its highest. As the likelihood of a claim reduces as time progresses, so the cost of a run-off policy generally reduces year on year.

Whilst the majority of claims are made within a few years of the work being completed, it is still possible for a claim to go back a number of years. CIOT and ATT require all members to maintain run-off cover for a period of no less than six years from ceasing public practice.

Selling the firm

If the firm is not closed down but is instead subsumed into a new business, then – depending on the manner in which that takes place, and if the purchaser took on the historic liabilities – run-off cover may not be required by the vendor, and those exposures may not be faced.

However, the vendor may still have some exposure arising through the sale and purchase agreement. It will still be in their interest to undertake that review, and take steps to manage and mitigate that risk as far as possible in advance of sale.

More significantly, a well-run business with good clear risk management in place is more likely to attract a higher sale price.

The firm may well have been sold subject to an earn-out, whereby part of the purchase price is paid at the time of the acquisition, and the remainder is contingent upon the business’s performance after the acquisition. The likelihood of claims arising during the earn-out is lower if appropriate steps have been taken to manage risk and any issues have been identified prior to the sale.

The firm should therefore consider being able to demonstrate the processes it employs to manage risk, that claims are unlikely to arise, that a detailed and independent review has been undertaken of its risk profile, and that any ‘hidden issues’ have been resolved. This will give the firm the chance to put right any issues prior to sale to improve the sale value, and avoid any later claims affecting earn-out or payment of warranties and indemnities. See ***Earn-out arrangements*** for further details.

Earn-out arrangements

An ‘earn-out’ will often occur when a business is sold and there is difficulty in agreeing a value fair to both vendor and purchaser. In such circumstances, an earn-out represents part of the consideration for the purchase of the business; i.e. the part which, following negotiations between the parties, is unascertainable.

Typically, the vendor will receive a cash sum, plus an ‘earn-out’ consisting of a right to receive an amount of deferred cash consideration (or loan notes or securities) dependent on the performance of the newly acquired business over a defined period following the purchase, payable at the end of the period or at various stages during the period.

In effect, the vendor will receive additional compensation if the business meets certain financial targets, such as gross sales or earnings.

In practice: how planning can help!

Firm A had two distinct practice areas: one which had a very bad claims history; and one which had a very good claims history. It restructured the two practices into separate businesses with different insurances for each.

Firm A undertook detailed reviews of both practices areas by independent risk experts. This established that although the first practice area had a bad claims history, the claims history was historic and was unlikely to repeat, leading to reduced premiums going forward. The second practice area had a good claims history and that was likely to remain.

Both practice areas then undertook a review of their processes, which they then implemented. These demonstrated that they were clearly managing risk well going forward.

Firm A then sold the second practice area for a significant sum. (It was clear that the first practice was not attractive in the market and Firm A had received advice that it could sell the second practice for more than it could sell both together.)

In due course, Firm A closed down the first practice. However, the cost of run-off was based upon the improved profile of that practice, and so was a reduced sum which Firm A had planned and budgeted for as part of the overall process.

This might be an extreme example, but it does show that early preparation can lead to significant savings and increased sale prices, as well as avoiding nasty surprises after the event!

In the next article in this series, Karen will explore the issues involved in purchasing a professional services firm.

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