James D. Cotterman

Getting the Capital Structure Right

By James D. Cotterman

"How much capital do we need in order to be properly capitalized?" is a question I am often asked. In this time of economic uncertainty, it is an even more appropriate question.

The need for capital is perhaps one of the most confusing and misunderstood issues among law firm partners. How much capital is needed is an even larger challenge to get agreement on. This article will help educate your lawyers as to the changing need for better capitalization, how to determine how much capital is needed and how to rationally (and safely) use debt in the capital structure.

How To Begin

I am often asked what the proper capital structure is for a law firm. Later in this article we will explore guidelines, but in designing a capital structure for any particular law firm one must first start with the purpose of the organization, the partners' financial tolerance and the dynamic shifts in the marketplace over 30 years.

Most law firms operate on a modified cash basis of accounting. Partners generally have relatively modest buy-in obligations and are entitled to equally modest buy-outs. These partners do not view the firm as a vehicle to accumulate wealth or provide for retirement,[1] at least not in the value of the organization. There are good reasons for this that are best left to a separate article on law firm valuation. For now, let's accept the proposition that, for many, the business we call a law firm does not build wealth like many of the business corporations that lawyers serve. Speak with partners in these firms and you are confronted with a healthy dose of skepticism about the owners investing much of their own money in the form of capital.

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There are some law firms whose owners view this issue differently and see the accumulation of an equity position as at least an important component of their personal balance sheet, if not also a component of retirement security. At these firms, one will gain a more receptive audience with respect to owner investment in the firm. Partners in these firms often rely less on borrowed money to capitalize the firm.

The Role of Debt Tolerance

Partners, and their law firms, have a range of attitudes about debt, personal risk, investment and the like. We all know the extremes. On one side, there is the individual who has no debt (no mortgage, no car loans, no education debt and pays credit cards in full each month), has a year of living expenses in cash reserves and invests heavily for retirement. On the other side is the individual who has borrowed heavily (home, second home, cars, education, credit cards), lives from paycheck-to-paycheck with little or no emergency cash and little savings.

The collective financial personalities of the partners are reflected in their partnerships. On one side are the firms that carry no debt (including minimal accounts payable balances). They finance all fixed assets out of current cash flow, maintain three months of operating expenses in cash reserves at year-end, the partners take out only 90% of their earnings each year (which are paid out before year-end) and have a line of credit so little used that their bank officers call them up and implore them to draw on it even if they pay it all back two weeks later, just to show activity on the account. On the other side is the law firm with little cash; accounts payable are at least 90 days old; the line of credit is usually at its limit; even at year-end debt is so high that the banks are constantly pressuring about covenants; last years' profits are barely paid out by Labor Day of the following year; and to top it off, they are pressured to meet certain targets so that last year's books are left open, dare I say, into February? Most firms lie somewhere in

between these two extremes, as do most individuals. The important point is that some individuals and some law firms have higher tolerance for debt than others. This "debt tolerance quotient" must be your starting point in designing a capital structure — understand the risk tolerance of the organization, and also of its partners.

Effect of Changing Growth Strategies

Now consider how law firms have evolved over the last 30 years. Firm size and their geographic coverage have exploded. Homegrown firms where lawyers joined out of law school and practiced an entire career have been replaced by firms with more lateral insertions than homegrown lawyers. Growth through organic means has been largely supplanted by growth through acquisition. Setting aside the cultural issues this raises, this growth strategy fundamentally alters the capital requirements of a firm. Acquisition growth tends to be a much larger undertaking, requiring even greater capital availability. One mitigating factor has been the shift from unfunded retirement programs to funded pension programs, either qualified or through insurance products. The latter has given rise to an opportunity to reduce capital requirements as post withdrawal income obligations are being funded currently.

What Are They Using All That Capital for Anyway?

Thirty years ago the then modern law firm needed modest capital to operate. Clients were serviced and then billed for those services. The law firms were paid and in turn paid their bills and compensated their partners. In some respects that basic cycle continues today.

The business of law has become a much more expensive proposition, however. Everything from salaries and benefits to technology infrastructure, to space and the need to market, have increased. Still, if the basic premise remains, what are they using all that capital for anyway? Not an unreasonable question. Law firms need capital to cover the cash gap that all businesses have. They also need capital for growth. Furthermore, capital is needed for the technology driven infrastructure of law practice today.

> ***"... some law firms have higher tolerance for debt than others. This 'debt tolerance quotient' must be your starting point in designing a capital structure ..."***

The cash gap in a law firm is the difference between when you pay your expenses and when clients pay you. For law firms, this number is usually about 105 days. Unbilled time usually turns over in 60 to 70 days. Accounts receivable turn over in 60 to 80 days. Accounts payable are generally around 30 days. With labor costs being the single largest overhead item in a law firm (usually paid bi-weekly or semi-monthly), the burden is aggravated because the labor cash gap is closer to 120 days. The resurgence of rampant associate wage increases in the late 1990s compounded the situation further.

What this means is that as you operate your business, you are likely to have paid for the services rendered before you have billed the client. This is part of the gap that generates the need for capital. If the business is growing, the cash gap is more critical to understand and manage. It is possible to grow a business so rapidly that you can literally grow it into bankruptcy. Why? Because the growth requires ever-increasing outlays of cash, and meanwhile the growth in cash receipts lags. If your capital is inadequate, you consume all of your cash and are in trouble. There are law firms in America today that are in this precise position.

Think about what happens as you add an associate. Day one the associate begins work. Yours is an efficient law firm — the associate is put on billable work fairly quickly. So by the end of the second week, when the individual receives their first paycheck, he or she is busy on client work. At the end of the month, the second paycheck comes; the associate is still busy. The first of the second month, benefits begin and the attendant premium costs are paid in advance (for some policies an additional month's premium is paid as an advance deposit). At the middle of the second month, the partner returns the prebills to accounting and the third paycheck is issued to the new associate. At the end of the second month, the bill is mailed to the client and the fourth paycheck is issued. By now you can see where this is heading. We are up to four paychecks by the time a bill has gone out (if you are lucky), and we have not mentioned paying for the laptop computer or other direct marginal costs of the individual. We have also not mentioned incremental general overhead or the 60 days or so until the client pays. Multiply that cost by inefficiencies along the way and then again by the number of associates you hire each year.

Consider also technology costs. Computers that are obsolete after two to four years have replaced the

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typewriters that used to last 20 years. Worse yet, the typewriters were only purchased for the secretaries and today everyone has a computer (and many have laptops). Phone systems are more complex (and expensive). In fact, the entire communication infrastructure of a law firm has changed — phone, fax, voicemail, pagers, cell phones, e-mail, videoconference, Internet, integration of voice/data/video, PDAs. All of these marvels require technology infrastructure and highly skilled (read expensive) people to deploy and manage them. Add in copiers, printers, fax machines, scanners, video projectors, and interoffice communication. All of that requires capital.

Clearly, whether it's business growth, inflation of wages and overhead, technology advances, or credit terms with suppliers and clients, there is a heightened need for capital. The primary sources for capital are the owners and their bankers. Landlords help, particularly when they absorb the initial cost of the build-out. This is not too dissimilar for those law firms that have purchased real estate to house their operations, since the partners of those firms must arrange for the financing of those investments through mortgage loans at banks, private placements or capital contributions. Leasing technology equipment has burgeoned as a means to create off-balance sheet financing to reduce the need for partners to finance these assets via capital contributions or debt. Today firms are equally likely to use leases, debt or cash purchases to acquire their technology, depending on the respective financing deals available when the technology was acquired.

> ***"... it does not take more than one or two significant client losses to initiate a cascade towards dissolution if one is not vigilant."***

The Potential Perils Of Debt

What does it really mean when you borrow money?

1. The organization can grow faster than it could if it were restricted to the capital supplied by the owners.

2. The cost of growth or fixed assets is spread across those who are likely to benefit from it.

3. You have to pay it back, and depending on what you used it for, there may be some unpleasant tax consequences at that time.

4. The organization that provided the loan expects you to live within the bounds of the lending agreement.

Let us not forget leasing — it is debt, just off-balance sheet. We are not talking about the abusive off-balance sheet financing behavior recently made famous or infamous by a few large corporations. We are referring to standard financing techniques for space, technology, vehicles and other equipment. They do represent an obligation of the firm, and hence of its partners.

Law firms, even recently, have dissolved over excessive debt burdens. It happened to Finley Kumble in the eighties and more recently to Brobeck. And once you begin to rely too heavily on debt financing it does not take long to find oneself in such a condition. Managing partners talk about building "the platform," adding people and offices like so many pins on a map. As that is accomplished so is the infrastructure of support and technology, space and build-out, and marketing that require those people to remain for many years producing revenue to pay for the investments. It does not take much of a change in the number of people for the infrastructure investment to become an overwhelming burden on the remaining partners. Carried one step further, it does not take more than one or two significant client losses to initiate a cascade towards dissolution if one is not vigilant. There are numerous recent examples. Such is the fragile nature of professional service organizations.

Bankers and Debt

One would think that all bankers would now be attuned to law firm fragility, having seen some of the public failures over the last few years. This is not necessarily the case. I have recently worked with two law firms in serious condition, both on the brink of possible dissolution, whose bankers seemed unaware of the firm's predicament. In fact, in one firm the bankers were pressing it to take on even more debt when the current debt was about to cause the firm's demise. This is an indication that firms should not rely on their bankers' underwriting to provide comfort, in terms of capital structures. That analysis and decision is yours.

Some bankers, however, have become more astute at scrutinizing law firms as businesses. Questions regarding the nature and stability of the partnership structure, governance, management, and client base are now quite common. It is typical for a new relationship to involve an

analysis of the firm's five-year history of partner activity. How many were promoted from the associate ranks, lateral insertions, retirements, competitive withdrawals and the like? What do the organizational documents say about governance and management? Who are in these positions and for how long? What are the protocols for owners to buy in and contribute capital? How much of current income is annually retained in the firm for future capital needs?

Questions regarding clients likely include a request for a list of the top 20 to 50 clients (in order of declining fee revenue) for each of the past five years as well as the client industry, nature of work, special fee arrangements, how they came to the firm and who maintains the relationships (yes, bankers understand about rainmaking). The patterns of growth or decline, client concentration and industry concentration are all part of the analysis.

Some banks extend their review to the associate ranks to gain a sense of what kinds of decisions are being made about future partners. For longer-term loans or leases, this exploration may help uncover how the future of the firm will unfold.

Debt and Taxes

Some law firms borrow and use the proceeds to compensate their partners. This practice may create a tax benefit to the partners in the year it is paid out, but this benefit reverses when the debt obligation is repaid to the bank. A brief explanation of the tax implications of such actions follows.

Partnerships. A partner computes taxable income on his or her share of partnership income and the pass-through items of deduction and credit. The partner receives a K-1 from the law firm summarizing this information. The partner does not receive a W-2 as employees do, because a partner is not an employee, but rather is self-employed. The cash distributions a partner receives from the law firm partnership may or may not correlate with the taxable income he or she must report to the Internal Revenue Service.

For example, if a partnership borrows $500,000 and distributes the funds to the partners, the transaction has no income tax effect for the partnership or the partners. The partners are often jointly and severally liable for repayment of the partnership debt. Interest paid for use of the money is a partnership expense, and hence tax deductible.

The good news: The partners receive the borrowed money free from income taxes. The bad news: When the partnership repays the bank, it uses fee receipts, which normally are used to fund current operations and partner draws. This reduces the monies available for partner distributions. The repayment of the loan is not a partnership expense. The partners report taxable income on the funds that were paid to the bank. For some partners, the prior year windfall has already been spent, and the tax bill represents a financial hardship.

Corporations. If a professional corporation borrows $500,000 and distributes the funds to the shareholders, the payments to the shareholders normally represent compensation that is deductible by the professional corporation and taxable income to the shareholder-employees. The shareholders pay the appropriate federal, state and local income taxes on the funds. The professional corporation pays interest on the full amount borrowed. Interest is deductible.

Some professional corporations use this technique to eliminate taxable income at year-end. Such actions become necessary because of differing loan amortization and fixed asset depreciation schedules or miscalculations in planning. However, such action should be minimal and rare. When used, the funds should be repaid in the first month or at least by the end of the first quarter of the following year to minimize interest costs. Until the depreciation/amortization imbalance corrects itself, the other problems reverse, or additional capital is raised, this use of debt will continue to be necessary.

If, however, the borrowed funds were simply an advance against future income, there will come the day of reckoning when the borrowed funds must be repaid, creating taxable income at the corporate level. The worst possible situation occurs at that time as the professional corporation pays federal, state and local income taxes on the taxable income. The shareholders not only have reduced their current income by repaying the debt, but also have given taxing authorities a significant portion of the original principal.

Quick Test: How Much Debt?

The metrics at the end of this article and the exercise (and the included examples) are intended as a quick check and should not be taken as a determinative judgment of a firm's fiscal condition. Failure to meet any of the standards should prompt further examination before judgment is rendered. Law firms may not meet one or more of these metrics and yet still be okay. All metrics are as of the end of your fiscal year.

1 For the moment we exclude the remunerative aspects of compensation, benefits and qualified retirement programs, which in combination can provide for the accumulation of personal wealth and retirement security.

James D. Cotterman *is a principal of Altman Weil, Inc., working out of the firm's offices in Newtown Square, PA. He can be reached at (610) 886-2000 or jdcotterman@altmanweil.com.*

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Quick Test

Use this analysis for each of the two sample firms described below — one is a 60-lawyer firm with debt problems; the other is an average 60-lawyer firm:

1. Add together the collectable value of your unbilled time and accounts receivable. The combination should be five times your total debt (bank and capitalized lease obligations).

2. The total amount of debt should be no more than 100% of the net book value of your fixed assets; 90% is okay, but 80% or less is much better.

3. Your line of credit balance should be zero at year-end and for most of the year. The credit line should not be used to pay partners or be used as your first source of working capital. It should be there to augment working capital, covering unusual economic conditions (i.e. negative economic performance beyond one standard deviation of norm).

4. The capital or owners' equity section of your cash basis balance sheet should be positive after all current year income has been distributed. This is your permanent capital.

5. You should not be in breach of any of your loan covenants. There are many covenants that you and your bank agreed to when the loan was secured (they vary from bank-to-bank and loan-to-loan). It is important to ensure that those covenants can be met. Failure to do so can result in higher interest rates being charged, possibly additional fees assessed, and even the loan being called. Technically, the bank can declare you to be in default if they are violated, and can exercise any rights they have under the default provisions of the loan agreement. If you are in default, get out in front of the issue — prepare a presentation to disclose the problem, put it into as favorable and honest a context as possible, show what corrective action is being taken, and ask for a waiver during the corrective period.

Sample 1: A 60-lawyer firm with debt problems:

Assets	
Cash	$1,900,000
Net Fixed Assets	1,200,000
Other Assets	1,300,000
Total Assets	$4,400,000
Liabilities	
Term Debt / Capitalized leases	$1,400,000
Line of Credit	2,000,000
Other Liabilities	500,000
Total Liabilities	3,900,000
Capital/Equity	
Permanent Capital	$300,000
Undistributed Income	200,000
Total Capital	500,000
Total Liabilities and Capital	$4,400,000
Off Balance Sheet Assets	
Unbilled Time	$2,800,000
Accounts Receivable	2,500,000
Total	$5,300,000

Quick Test Results — Sample 1

1. Unbilled time plus accounts receivable : Debt
   $5,300,000 : $3,400,000 = 1.56, which is less than 5

2. Debt/Net Fixed Assets
   $3,400,000 / $1,200,000 = 283%, quite obviously higher than 90%

   If you paid off the line of credit the term debt is still too high ($1,400,000 / $1,200,000 = 117%)

3. Line of Credit Balance
   Year-end balance is $2,000,000. It should be zero.

4. Permanent Capital
   Year-end balance is $300,000, which is still positive.

Sample 2: An average 60-lawyer firm:

Assets	
Current Assets	$2,100,000
Net Fixed Assets	1,500,000
Other Assets	400,000
Total Assets	$4,000,000
Liabilities	
Term Debt / Capitalized leases	$1,000,000
Line of Credit	0
Other Liabilities	700,000
Total Liabilities	1,700,000
Capital/Equity	
Permanent Capital	$1,000,000
Undistributed Income	1,300,000
Total Capital	2,300,000
Total Liabilities and Capital	$4,000,000
Off Balance Sheet Assets	
Unbilled Time	$3,800,000
Accounts Receivable	3,600,000
Total	$7,400,000

Quick Test Results — Sample 2

1. Unbilled time plus accounts receivable : Debt
   $7,400,000 : $1,000,000 = 7.4, which is greater than 5 times

2. Debt/Net Fixed Assets
   $1,000,000 / $1,500,000 = 67%, which is lower than 90%

3. Line of Credit Balance
   Year-end balance is $0. It should be and is zero.

4. Permanent Capital
   Year-end balance is $1,000,000, which is positive and there appears to be sufficient current assets (predominately cash in most law firms) to pay out the undistributed income.

Fiscal Metrics to Gauge Your Firm's Financial Health

What are the benchmarks for the fiscal health of a law firm? There are many — some come from the bankers, some from financial advisors and some are internally-driven by the comfort the owners have with financial leverage. Broad normal ranges of the most common metrics (specific, appropriate metric values are determined by firm size, practice focus and other factors) follow:

	Normal Range	
Metric	**Low**	**High**
Revenues per lawyer	$375,000	$575,000
Revenues per equity partner	$700,000	$1,800,000
Overhead per lawyer	$150,000	$250,000
Occupancy costs/revenues	6.5%	8.5%
Income per lawyer/revenue per lawyer	55%	65%
Gross profit margin	35%	45%
Average equity partner income	$325,000	$600,000
Income per equity partner/revenue per lawyer	90%	115%
Distributions per equity partner/income per equity partner	93%	98%
Net cash available for working capital	2 weeks	12 weeks
WIP over 180 days/total WIP	20%	33%
Investment in WIP (# months at year-end)	2.00	2.50
AR over 180 days/total AR	22%	36%
Invest in AR (# of months at year-end)	2.25	3.00
WIP + AR : debt	7.0	14.0
Debt per equity partner	$12,000	$90,000
Debt/net fixed assets	50%	75%
Debt/equity partner compensation	8%	13%
Total liabilities per equity partner	$40,000	$125,000
Total liabilities/WIP + AR	8.5%	14%
Total liabilities/equity partner compensation	15%	23%
Permanent capital per lawyer	$30,000	$60,000
Permanent capital per equity partner	$75,000	$160,000
Permanent capital/WIP + AR	12%	30%
Permanent capital/revenues	5%	10%
Permanent capital/equity partner compensation	12%	27%
Realization from standard rates	85%	90%
Leverage (all non-equity partner lawyers : equity partners	1.2	2.2
Billable hours/partner	1,725	1,850
Billable hours/associates	1,750	1,900
Billable hours/paralegal	1,350	1,500