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Law Firm Capitalization

James D. Cotterman

By James D. Cotterman

Why do you need capital? Capital is necessary to provide working capital and to fund client costs advanced, fixed assets, growth, retirement and unforeseen events.

Working Capital

Sustained, regular, positive cash flow is the lifeblood of any business. It does not matter if you are Exxon or the neighborhood coffee shop. Positive cash flow is a requirement. That basic concept was temporarily forgotten with the dot-com companies in the latter half of the 1990s. The sudden and severe loss of market value in those companies during the first years of the new millennium was primarily due to the re-emergence of this business fundamental.

Cash flow is not the same thing as income. Even for law firms who almost universally measure their economic performance on the cash basis, there are borrowings, loan payments, fixed asset purchases and depreciation that affect income and cash flow differently. Obviously these financing and investment activities are important, but they are not where law firms get into trouble (unless they have financed operations instead of investments). Generally, trouble occurs if there is insufficient focus on the cash receipts generated from accounts receivable and the cash payments generated by payroll and accounts payable.

The cash gap in a law firm is defined as the difference in time between when you pay your expenses and when clients pay you. For law firms, this number has historically been about 105 days. Unbilled time 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 the single largest overhead item (usually paid bi-weekly or semi-monthly), the burden is aggravated because labor's cash gap is closer to 120 days. Each time competitive pressures raise associate wages, this situation becomes more acute.

What this means is that as you operate your business, you are likely to have paid the costs to render services before you have even invoiced the client. If your time recording, billing and collection processes are inefficient or ineffective, your ability to promptly generate timely fee collections is severely strained. As an executive director I know continually reminds his partners,

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"If we do not have time in the system, we cannot bill our clients. If we cannot bill for services, money does not come in the door. If we have no money, we cannot pay bills...." So simple, yet successfully managing this basic function remains a problem in some law firms.

Client Costs Advanced

Client costs advanced are interest free loans to clients. Some firms expense these advances and reflect the reimbursement as income, although this is not the method the IRS generally favors. At least this method eliminates the adverse tax consequences of these investments. In most instances, however, the law firm records these advances as assets and the reimbursements as payments on those receivables. The only tax deduction then comes when an advance is deemed uncollectible and is written off.

In most general practice firms this investment is $18,000 to $22,000 per partner. Not so bad, but a plaintiff contingent litigation practice averages nearly five times that at $94,000 per partner. Even higher are the intellectual property practices where client costs advanced are averaging $166,000 per partner or over eight times the average firm! This is a significant capital investment that is permanent and growing, and it does not include the portion floated by vendors in the payment terms they grant the law firm.

Consider the hot, highly profitable practices that larger firms more and more are entering — contingent fee and intellectual property matters (i.e., the very two with substantially higher client costs advanced). Often the economic models are not well understood by partners in other practice areas, leading to some tense partner meetings. Capital needs should be determined for each major practice and rolled up into an overall firm program. An executive director's perfect storm is the managing partner announcing her intention to establish and grow these practices by way of lateral insertions. In such case, you get both client costs advanced and working capital stress all at once!

Retainers and direct billing to clients by the vendors are two common alternatives to the firm raising the necessary capital. Some firms have financed their client costs and back-charge the clients for their portion of the interest costs on that debt. Software programs exist that track the client advances, allocate interest based on actual client responsibility for the debt, and reconcile client back-charges to actual interest paid by the firm.

Yet all three of those alternatives are not widely utilized by the profession, as evidenced by the ongoing significant investments law firms are making. A competitive legal market and client reluctance are likely reasons for the slow acceptance.

Fixed Assets

Fixed assets are improvements to space and facilities, technology and communication systems, and libraries for those who have not yet fully migrated to online versions. The infrastructure to run a law firm does not become a smaller partner burden as a firm grows. Small law firms average about $19,000 per partner in net book value of fixed assets. Mid-size firms average $37,000 per partner. Large firms average $102,000, or about 5.4 times the small law firm average.

The fastest rising capital investment needs are usually associated with technology and communication costs. Lawyer's standard-issue laptops are attached to a docking station with a flat panel monitor, keyboard, speakers and a mouse and quite possibly a private laser printer. Similarly outfitted desktops are provided for all staff. Smart phones with Bluetooth technology are standard issue for lawyers. Instant and text messaging, along with their unique language protocols, are becoming common forms of communication. Video conferencing, having already been accepted in the conference room, may be moving to the desktop. All of these technological marvels require technology infrastructure, and this infrastructure requires frequent renewal. Payback and useful life are measured in a few years, while technical obsolescence can be measured in months.

Law firms will often use third-party capital to finance these investments. Debt and leases are the most frequent methods used to reduce the burden on current partners and to distribute it among current and future owners who will benefit from the investment. Deal structure is important. Leasehold improvements should be built into the landlord's lease whenever possible. This keeps those investments tied to the term of the lease which is almost always shorter than the "useful life" for depreciation. Repayment terms for debt and capital leases should be aligned with depreciation schedules for other assets as much as possible to reduce adverse tax consequences. This is generally a good use of term debt with fixed interest rates.

Growth

Now consider how law firms have evolved over the last 30 years. Firm size and geographic coverage have exploded. Growth through organic means has been largely supplanted by growth through acquisition, resulting in many firms having more lateral insertions than lawyers who practiced their entire career with the firm. Setting aside the cultural issues this raises, this growth strategy fundamentally alters the capital requirements of law firms. Acquisition growth tends to be a much larger undertaking, requiring even greater capital availability.

The capital drain of a growing business is a critical issue to understand. It is possible to grow a business

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so rapidly that you literally grow it into bankruptcy. (Even a profitable business can falter.) Why? Because the growth requires ever-increasing outlays of cash. Meanwhile, the growth in cash receipts lag. If a firm's capital is inadequate, the firm consumes all of its cash and it is in trouble.

Think about what happens as you add an associate. On day one the associate begins work. Yours is an efficient law firm — the associate is put on billable matters fairly quickly. So, by the end of the second week, when the individual receives the 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 day of the second month, benefits begin. At the middle of the second month, the partner returns the pre-bills 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, and we have not mentioned paying for the laptop computer or other direct marginal costs of the individual, let alone any incremental, general overhead. Did we mention the 60 days or more until the client pays? Multiply that cost by inefficiencies along the way and then again by the number of associates you hire each year.

This is the hidden cost of today's growth profile. Growth of new hires used to be almost exclusively new law school graduates and the staff who support them. Consider the example above for a new associate. The increased use of lateral hires has taken that investment further. No longer are the least expensive lawyers being funded at start-up. Now much more significant costs must be covered. The investment cycle is the same but the numbers are larger.

Retirement

One mitigating factor in capital need 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 on a current basis. The return of capital and the funding of even modest unfunded arrangements, however, are yet to be seen in truly large numbers. The next ten years will bring this demographic phenomenon into full play. Historically, the cost of retirement has been easily offset by the addition of new partners. Stricter admission standards and a profession that may reach size equilibrium will alter this equation.

The benefits paid in an unfunded retirement program are a tax on current income. That tax must be accepted as fair and bearable, or otherwise the current partners will declare the tax null and void. Unsecured promises to pay benefits will not survive the demise of the firm. Such failures can happen by design — partners vote to dissolve, or key partners depart with their clients, leaving a weakened, unsustainable firm behind. Generally a tax less than 5% of owner compensation is affordable, under 3% even better. Over 7% is dangerous and over 10% probably unsustainable.

The trickier part of retirement is the large capital accounts of senior partners that will become due over the next ten to 20 years. They can be partially offset by the capital contributions of new partners. However, those contributions will be much less on a per capita basis than the capital accounts of those retiring. And there may be fewer new partners than retiring partners. Those dynamics result in a probable capital drain requiring capital calls or long-term capital accumulation programs. Leaving 3% to 7% of earnings in the firm annually is a good way to build an investment mentality. If the liquidity of those investments can be secured, it will provide the reserves required to weather the baby-boomer generation retirements.

The Unforeseen

Partners, and collectively their respective 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 20% of his or her income 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 (possibly there is a home equity line that has been tapped), and little is saved.

The collective financial personalities of the partners are reflected in the partnership. On one side are the firms that carry no debt (including minimal accounts payable balances) — financing all fixed assets out of current cash flow, maintaining three months of operating expenses in cash reserves at year-end, having the partners take out only 90% of their earnings each year (which are paid out before year-end) and having a line of credit that is used so infrequently that the bank officer calls to 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 of at least 90 days old, a line of credit that is usually at its limit, even at year-end, debt that is so high the banks are constantly pressuring about covenants, where last years' profits are barely paid out by Labor Day of the following year, and to top it off, where they are so pressured to meet certain targets that last

year's books are left open, possibly as late as February.

Most firms lie somewhere in between the 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 the starting point in designing a capital structure. It is important to understand the risk tolerance of the organization, and its partners as well.

While presenting a very conservative set of recommendations regarding capital, one partner interrupted me and asked why the firm should have "his" money to use (actually the word used was "squander"). He specifically wanted me to chronicle the need for each dollar he was being asked to leave in the firm. A fair question to ask and one that offered a glimpse into his philosophy. I responded that his partners were largely a fiscally conservative group. They wanted comfort that the firm could adequately face the known and weather the unknown events of the future. That yes, less owner capital was possible, and yes, the firm could safely borrow more. But what I had laid out was the ideal capital structure needed to accommodate the collective philosophy of the firm's owners. I often refer to this as the sleep factor — that is, all the financial ratios in the world are meaningless if the owners can't get a good night's sleep because they have borrowed too much.

Balance Sheet Management

The "Quick Test" described below has been designed to help assess a firm's fiscal condition, however it should not be taken as a determinative judgement. 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 still be okay. All metrics are as of the end of a firm's fiscal year.

Quick Test:

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). An available line of credit equal to the funds required to cover one month of payroll (including owners) is one rule of thumb.

4. The capital or owners' equity section of your cash basis balance sheet should be positive after all current year income, accrued retirement contributions and accounts payable have been paid. This is your permanent capital. There should also be sufficient liquidity (cash) to fund at least two weeks of operating expenses (including partner draws).

5. You should not be in breach of any of the loan 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 exercise any rights they have under the default provisions of the loan agreement. If you are in breach, 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.

On pages 10 and 11 you will see four illustrative scenarios employing the Quick Test.

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

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FOUR SCENARIOS EMPLOYING THE "QUICK TEST"

A 60-LAWYER FIRM WITH PROBLEMS

Assets	
Current Assets	$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

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

2. Debt/Net Fixed Assets
$3,400,000 / $1,200,000 = 283%, quite obviously higher than 90%
If you pay 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. Current assets (predominantly cash) are significant, but liquidity is insufficient to handle line of credit balances, other liabilities (often the accrued retirement plan contribution) and working capital for the coming year.

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

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 appear to be sufficient current assets (predominately cash) to pay out the undistributed income and other liabilities (often the accrued retirement plan contribution), but remaining liquidity is insufficient for the coming year s working capital needs.

A 150-LAWYER FIRM WITH PROBLEMS

Assets	
Current Assets	$4,800,000
Net Fixed Assets	3,000,000
Other Assets	3,300,000
Total Assets	$11,100,000
Liabilities	
Term Debt / Capitalized leases	$3,500,000
Line of Credit	5,000,000
Other Liabilities	1,300,000
Total Liabilities	$9,800,000
Capital/Equity	
Permanent Capital	800,000
Undistributed Income	500,000
Total Capital	1,300,000
Total Liabilities and Capital	$11,100,000
Off Balance Sheet Assets	
Unbilled Time	$ 7,000,000
Accounts Receivable	6,300,000
Total	$13,300,000

QUICK TEST RESULTS

1. Unbilled time plus accounts receivable : Debt
$13,300,000 : $8,500,000 = 1.56, which is less than 5.

2. Debt / Net Fixed Assets
$8,500,000 / $3,000,000 = 283%, quite obviously higher than 90%
If you paid off the line of credit, the term debt is still too high ($3,500,000 / $3,000,000 = 117%).

3. Line of Credit Balance
Year-end balance is $5,000,000. It should be zero.

4. Permanent Capital
Year-end balance is $800,000, which is still positive. However, there is insufficient cash to pay the line of credit, let alone the other liabilities and year-end profits. While current assets are significant, there is nowhere near enough liquidity to meet current needs.

AN AVERAGE 150-LAWYER FIRM

Assets	
Current Assets	$7,800,000
Net Fixed Assets	6,300,000
Other Assets	900,000
Total Assets	$15,000,000
Liabilities	
Term Debt / Capitalized Leases	$3,500,000
Line of Credit	0
Other Liabilities	1,300,000
Total Liabilities	$4,800,000
Capital/Equity	
Permanent Capital	2,700,000
Undistributed Income	7,500,000
Total Capital	10,200,000
Total Liabilities and Capital	$15,000,000
Off Balance Sheet Assets	
Unbilled Time	$ 9,800,000
Accounts Receivable	10,700,000
Total	$20,500,000

QUICK CHECK RESULTS

1. Unbilled time plus accounts receivable : Debt
$20,500,000 : $3,500,000 = 5.9, which is greater than 5 times.

2. Debt / Net Fixed Assets
$3,500,000 / $6,300,000 = 56%, 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 $2,700,000, which is positive and there appear to be sufficient current assets (predominately cash in most law firms) to pay out the undistributed income, although there does not appear to be sufficient cash to fund distributions and pay the other liabilities and still have cash on hand to provide the initial working capital in the new year without reliance on the line of credit.

Capitalization... *continued from page 9*

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.

The Hidden Capital Contributions

Law firm partner compensation is the result of the components set out below. Few law firms distinguish between them and it may be fair to say few partners even think of their compensation in this way. If, however, the partners did take this view, they might pay better attention to how each of these elements affects what they take home:

1. The fair exchange for one's labor — partners are very much active workers in the business. They must be productive in fee generation both as originators and as timekeepers.

2. PLUS profits from the labors of non-owners — all non-owner timekeepers should be profitable. They are consistently and significantly profitable in the top firms.

3. LESS the current cost of growth — investing in new people, offices, practices and markets is often funded out of current cash flow. Since firms deduct these expenses currently they are the hidden capital invested by owners to grow the business.

4. LESS the cash invested for capitalized assets — items shown on the asset side of the balance sheet when there is no corresponding third party obligation for funding those assets.

5. LESS the cash invested in higher salaries — higher pricing for those increased salaries often lags, as does the cash flow to pay for the increases.

James D. Cotterman *is a principal of Altman Weil, working out of the firm's offices in Florida. He can be reached at (407) 381-2426 or jdcotterman@altmanweil.com.*