Law Firm Debt: Will We Ever Learn?

By
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I have been commenting on appropriate debt and liquidity levels for law firms for most of my 24 years consulting to law firms. Recent events indicate that not everyone who should be paying attention has been.

Where are we?

- ↑ The recession is behind us.
- ↓ The recovery has been anemic compared to historic patterns (go to www.crgraphs.com and peruse twenty graphs that depict this rather starkly).
- ↓ Significant potential exists for disruptions (EU debt/deficits, Middle East unrest, Far East tensions, a dysfunctional US Congress and extreme weather events).
- ↑ Increased regulatory activity in our financial markets, compliance with the Patient Protection and Affordable Care Act and IP portfolio litigation contribute to early 2012 demand for legal services turning up after a disastrous 2nd half of 2011. Hopefully an upcoming IPO that many will "Like" will put a friendlier face on corporate transactions for the balance of 2012.
- ↓ Lawyer productivity is down due to hiring above demand supported levels.
- ↑ Legal services pricing is up.
- ↓ But not much more than inflation (a far cry from pre-recession increases) and is mitigated by decreasing realization – clients pressuring at all points in the process to reduce the final cost of delivered legal services.
- ↓ Law firm expenses (direct and indirect) are increasing at worrisome rates.
- ↑ Banks are lending to law firms (although some more than is wise).

So let us review a law firm balance sheet and provide a primer on debt and liquidity as well as some easy metrics that you can use as an early warning system.

These metrics 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 these 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 discussed below are as of the end of your fiscal year. There are distinct variances by size of law firm and for some specialized areas of practice.

Quick Balance Sheet Assessment Metrics:

Add together the collectable value of your unbilled time and accounts receivable. The combination should be 12 times your total debt (bank and capitalized lease obligations). This will change when new lease accounting rules are finalized and put into effect sometime in the next year or two. The rules are expected to end the use of operating leases – all operating leases.

The total amount of debt should be much less than 80% of your net fixed assets, although 80% is okay as an overall percent if you are early in an investment cycle. This measure will also change with the new lease accounting rule implementation mentioned above.

Your line of credit balance should be zero at year-end and for most of the year. Your available line should be sufficient to cover at least five weeks of revenue. The credit line should not be used to pay partners or as your first source of working capital. It should be there to augment working capital, covering unusual economic conditions.

The capital or owners' equity section of your cash basis balance sheet should be positive after all current year income and accrued pension has been paid out. In addition, there should be sufficient free cash (cash balance after current year income and accrued pension is paid) to cover at least a half month of operations, including partner draws.

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 are met. Failure to do so can result in higher interest rates, additional fees, and even the possibility of the loan being called. Technically the bank can declare you to be in default and 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, providing a candid and honest assessment and a corrective action plan. Ask for a waiver during the corrective period.

An average 250-lawyer firm:

Assets	
Cash and equivalents	$20,300,000
Other current assets	$1,100,000
Client costs advanced	$2,800,000
Net fixed assets	$10,300,000
Other assets	$1,300,000
Total Assets	**$35,800,000**
Liabilities	
Debt (LOC $300,000)	$3,600,000
Other current liabilities	$4,700,000
Other liabilities	$100,000
Total Liabilities	**$8,400,000**
Capital	
Permanent capital	$14,500,000
Undistributed income	$12,900,000
Total Capital	**$27,400,000**
Total Liabilities & Capital	**$35,800,000**
Off Balance Sheet Assets	
WIP	$25,900,000
AR	$30,800,000
Total	$56,700,000

Assessment:

Unbilled time plus accounts receivable / Debt
$56,700,000 / $3,600,000 = 15.75
This is safely above 12. A further look at WIP and AR indicates that both are reasonable relative to revenue; which gives comfort that the ultimate collectability of those assets is probably high.

Debt / Net Fixed Assets
$3,600,000 / $10,300,000 = 35%
This is a conservative use of financial leverage.

Line of Credit Balance
Year-end balance is $300,000. It should be zero, but since overall debt is quite low this is only a problem if you have agreed to have the line at zero at year-end.

Liquidity
Year-end cash of $20,300,000 is sufficient to pay out the $12,900,000 in current income plus $4,700,000 of current liabilities (mostly accrued pension contributions and payroll taxes). The remaining cash of $2,700,000 will cover a bit less than one week of operations. This is low; an additional $4,100,000 should be added to the working capital reserves in the future.

Permanent Capital
Year-end balance is $14,500,000, which is about $175,000 per partner, which is about $50,000 low (the above mentioned additional liquidity needed).

Summary

As the above example illustrates, a typical firm is likely to have a reasonably healthy balance sheet, but still not be well positioned. It is important to consider liquidity. Cash is your lifeline during stressful fiscal situations. Our very simple example looks at free cash flow, the more conservative approach to considering liquidity.

Remember that your firm size and practice mix will affect what is prudent. Large law firms with their multiple offices operating around the globe and around the clock have greater investment needs than a smaller single office law firm. Contingent fee firms have substantially greater capital and liquidity requirements than hourly practice firms.

There are other measures that firms can use to delve more deeply and specifically assess the firm's exposure. This article sets forth the first level of analysis that every firm should undertake - before it's too late.

About the Author

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