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Partner Capital Issues and Answers

James D. Cotterman

By James D. Cotterman

In a July issue of the *National Law Journal* there was a lead article titled, "Firms Ask Partners To Pony Up." That article sparked questions from our clients regarding law firm capital structures. This article pulls together a number of the issues we have been dealing with over the past month.

Issue 1: If partner capital has remained at a fairly consistent level as a percentage of revenues, why have capital requirements grown so substantially?

While partner capital may have remained a steady percentage of revenues in recent years, the growth rates in revenues and headcount have surpassed the rate of increase in equity partners. This is primarily the result of law firms aggressively promoting the non-equity position and filling those ranks with many lawyers who in prior decades would have become equity partners. Law firms were keen on managing reported earnings by erecting barriers to equity ownership and in many cases demoting some equity partners who did not meet more aggressive performance criteria.

Although some believe that tiered ownership increases equity partner compensation, it more often increases the reported averages by drawing the line higher up the scale. Rarely does it actually increase what individual partners earn. And some research suggests that this approach actually results in lower equity partner earnings.[1]

But, by implementing two-tier partnerships, law firms also have limited the growth in the number of owners contributing capital. Thus each equity owner must shoulder an increasing capital burden. If a law firm needs to restructure, it may need to prune the equity ranks while simultaneously raising capital and dealing with declining profits.

From 2001 to 2007, law firms strengthened their financial positions by investing more of their own money and improving liquidity, all while growing in size and profitability. Average equity partner cash basis capital at law firms over 150 lawyers increased from about $48,000 to over $110,000 during that period. Debt per equity partner decreased and the months of free cash flow rebounded from negative to positive. Table 1 at the top of page 2 is extracted from data in the *Survey of Law Firm Economics*.[2]

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Table 1. FIRMS WITH OVER 150 LAWYERS

Year	Debt	Equity	Months Free Cash Flow
2001	$60,000	$48,000	(0.12)
2007	$34,000	$110,000	0.15

Much of that progress may be undone in 2008 as firms grapple with the effects of the credit squeeze.

Issue 2: How have the credit markets affected our need for capital?

The credit market woes have curtailed deals and financings, very much the lifeblood of financial market law firms. Big ticket corporate litigation also seems to be down, the other major revenue and profit generator for large firms. The drop in workflow at some of these firms has been staggering. Shedding personnel, dealing with excess infrastructure and negotiating with lenders have overtaken growth as top priority issues for a number of firm leaders.

The pipeline — a law firm's investment in unbilled time, costs advanced and accounts receivable – has taken multiple hits. The volume of work has been drastically reduced, meaning less time value going into the system. And the accumulated investment in unbilled time has come under greater client scrutiny resulting in higher write-offs — and, accordingly, fewer billings to feed accounts receivable. Accounts receivable have grown, but so has the percentage of older receivables, as clients hoard their own cash more diligently. Add the tighter underwriting standards from banks, and the result is borrowing that is more difficult and more expensive to obtain. This combination has created a much greater need for partners to invest more in their own firms.

This all comes with profits declining, leaving partners squeezed between reduced income and calls for more capital — cash only, no credit accepted.

Issue 3: We have very little debt, so why is the bank questioning our line of credit use?

Banks view lines of credit as supplements to working capital, not permanent financing and certainly not in lieu of partner equity, which can be measured in terms of liquidity. The following example illustrates the point.

A firm had very little debt at year-end relative to its fixed assets. It also had very little cash relative to its undistributed profits, since it used its cash to fund capital improvements. As depicted in Table 2 below, the ratio of debt to net fixed assets was excellent; capital was okay. However, year-end free cash was negative resulting in a negative two months of free cash flow. This metric measures the amount of cash available at year-end after adjusting for unpaid profits, accrued profit sharing and other payables, and converts it to how many months of annual cash flow it represents. It is a measure of a firm's liquidity.

This firm used its line of credit primarily to fund distributions of prior year profits to partners in the following year. (Bankers are not keen to see debt used to fund partner incomes.)

The firm either should have converted a significant portion of its undistributed profits to permanent capital, or arranged permanent financing (term loans) to leverage the capital investments, or some of both, depending on its financial leverage tolerances. The point to take away is that even if a firm has low debt to net PPE and a reasonable average capital per partner statistic, the firm may still have dangerously low liquidity.

Issue 4: We borrowed heavily to grow and operate the firm. Now our capital accounts are negative and our accountant is pressuring us to contribute more capital. Why should we? Isn't it better to use the bank's money rather than ours?

This firm has monetized a sizable amount of its accounts receivable. It took those funds tax-free since the firm will not recognize the income until it collects the receivables. Further, it has no cash to run the business and future cash flow has been leveraged with debt. See Table 3 below.

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Table 2. KEY RELATIONSHIPS

Debt to Net PP&E	25%	Excellent; good is 50% to 75%; 85% is acceptable
Capital per partner	$150,000	Okay, but probably should be higher
Months free cash flow	(2.0)	Poor; should be positive 0.5, but 1.0 to 2.0 would be better

Table 3. KEY RELATIONSHIPS

Debt to Net PP&E	160%	Poor; 50% to 75% is good; 85% is acceptable
Months free cash flow	(0.5)	Poor; should be at least positive 0.5, but 1.0 to 2.0 would be better

Jim Wilber, editor of RTLM, has graciously given up this page in order to allow room for the valuable articles you'll find inside this issue. His column will return in the coming issues.

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The partners will eventually incur phantom income (taxable income with no corresponding cash flow) when this timing difference reverses, as a result of having taken tax-free distributions with borrowed money in the past. It will happen either when they pay back the debt out of earnings or contribute the capital, or are forgiven the negative capital account upon withdrawal. No matter how it happens, there will come a day of reckoning with the IRS.

Their accountant wanted to reverse this situation in a controlled manner to improve the balance sheet. The firm's local bank has not yet said anything, but the accountant is anticipating that will eventually change.

Issue 5: What is the advantage to having little or no long-term debt?

One advantage is not having the bank monitoring how you run the firm. Another is the absence of personal guarantees, which are generally invoked when the bank is looking for assurance beyond the firm's ability to pay. Having "skin in the game," as the saying goes, gives comfort to the lenders. Reduced interest expense is yet another advantage to the firm.

Some firms use the partners as the bank and pay them interest instead. This is a great way to give partners a return on equity and free the partner compensation program to recognize operational contributions rather than financial contributions of a partner.

But our experience is that many firms find recruiting laterals and doing deals easier if they maintain a healthy (low debt) balance sheet. And these firms probably have the wherewithal to incur debt if they have an opportunity they want to pursue.

There is a cost, however; and that is the increased cost of buying into these firms. It is essential that the firm be sufficiently profitable so that the capital calls are manageable relative to the income. That can be a challenge if your practices are on the wrong side of the economic cycle.

Issue 6: Why are firms asking for the money up front and taking longer to give it back?

Asking for the money up front builds capital more quickly and eases the burden on other partners already in the system. For example, if the firm needs each partner to contribute $120,000 and some partners are given three years to do so, then the remaining partners must carry the difference during those years. Asking the partner to sign a note with the bank or write a personal check makes the contribution much more real than saying the firm will take it out of distributions over time.

Taking longer to pay it back preserves capital. If a firm is poorly capitalized or is illiquid, this method might be a necessity. But down the road, as the Boomer generation retires, there will be a significant capital obligation that will come due. Law firms may want to position themselves now to spread that future cost over time. It is not so much the liquidity needed to pay these retiring partners their capital that is the issue as much as the firm's need to replace it immediately with new capital.

In summary, capital requirements are increasing at many firms despite the substantial gains firms made from 2001 to 2007 in revenues, headcount, and debt reduction. The credit crisis has exacerbated the problem. Despite having a low debt balance, banks are conducting greater due diligence with increased scrutiny of all new borrowings, especially where there is low liquidity. Firms with negative capital accounts will have to pay the piper at some point in the future – it cannot be avoided. No debt is a good thing – but it comes at a cost. Capital is precious. The combination of these issues explains why firms must preserve cash – something that is in short supply at many law firms this year. ◆

[1] See William D. Henderson, An Empirical Study Of Single-Tier Versus Two-Tier Partnerships In The Am Law 200, Indiana University School Of Law-Bloomington Legal Studies Research Paper Series (2006).

[2] The 2008 *Survey of Law Firm Economics* was conducted and published by Altman Weil Publications, Inc., a Division of Incisive Legal Intelligence. Readers can purchase a copy of the *Survey* by calling Incisive Legal Intelligence's survey group at (888) 782-7297 or online at www.lawcatalog.com.

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