The Importance of Law Firm Capital Planning

As law firms review their capitalization, they need to consider the costs of operations and strategic initiatives as well as those events that cannot be anticipated.

During the course of our work, clients periodically ask us to comment on their capital structure and use of bank financing. The specific analyses vary from firm to firm, but we often help the firm develop a capital plan and budget, establish a policy for capital contributions, analyze fixed asset acquisitions, review the appropriateness of the firm's debt load, streamline capital structures and policies in merging firms.

It is clear that, while one size does not fit all, there are three perspectives any firm that is reviewing its capitalization should consider: financing operations, financing strategic initiatives and financing unanticipated events.

Financing Operations

Most law firms finance their operations through a combination of two sources: partner capital and bank debt. Partner capital typically comes through a cash contribution (possibly a bank loan that the firm guarantees) and/or accumulated undistributed earnings. The procedure by which the firm calculates how much each individual needs to contribute varies significantly, and could well be the subject of a lengthy article on its own.

Regardless, in law firms, capital planning is often done with an eye towards financing the firm's current, expected operating needs. These needs vary by firm, but may include financing the firm's billing and collection cycle, fixed asset purchases, extraordinary expenses (office relocation for example) and possibly the creation of a cash cushion to cover short-term cash flow mismatches.

Of course, these costs can add up quickly, and firms rarely rely on partners to fund everything. Instead, firms look to bank financing to support some portion of operations, particularly when the expenditure is related to the acquisition of fixed assets or funding of extraordinary expenses.

Incurring debt to finance these items is almost an industry standard, and, when the loan is amortized as the asset is depreciated, repaying the debt is rarely a financial burden on the firm.

At one time, firms used "rules of thumb" when setting operating capital targets. One popular rule was setting the target equal to a certain number of months of operating expenses (two to three months was common). For some firms, this process probably worked well (and may still); however, as firms have grown and their geographic reach has expanded, relying on a rule of thumb to set capital has become increasingly risky. Quite simply, the connection between the capital needed to support a growing law firm and a rule of thumb based on firm expenses is tenuous, at best.

As we have seen over the past year or so, certain practices that were profitable and active have struggled to keep lawyers operating at anywhere near full capacity. Firms that were not interested in cutting off funding to the slower practices used existing capital to prop up the practices, with the hope that the lawyers would soon return to full capacity. Those firms that did not have adequate capital fell more quickly into a cashflow crunch when busy practices slowed down. They also tended to eliminate attorneys.

Now, rather than rely on rules of thumb, firms are beginning to set their capital targets based on firm expectations and planned strategic initiatives.

Strategic Initiatives

A firm's strategic initiatives often include planned growth, which, in turn, means more attorneys, more infrastructure costs and, possibly, more offices.

While such moves should pay for themselves in the long run, the start-up costs of adding a group of laterals or opening a new office can be significant. In the case of **lateral hires**, since the individuals joining the firm rarely bring their work-in-process and accounts receivable with them, the acquiring firm needs to finance the group's operations for some time.

Consequently, a firm's capital plan should consider the firm's strategic growth initiatives. In the case of a lateral expansion, many firms use bank financing to pay for any additional infrastructure, such as furniture and equipment. This is consistent with the use of debt to fund ongoing operations and is not inappropriate. Some firms will also use bank financing to fund the start-up costs for the new group. This can cause problems. While incurring a small amount of short-term debt to pay the start-up costs may be acceptable in certain instances, stronger firms use existing capital to fund these costs.

Too often, we see firms dip into bank loans to fund start-up costs, only to see that they cannot repay the loan anytime soon. Ultimately, this can limit future initiatives since partners have an appetite for only so much debt, particularly if it comes with personal guarantees.

The Unanticipated

Too many firms set capital policies and targets that focus solely on expected operations and fail to plan for unexpected cash needs. The nature of these unanticipated events can range from the loss of a key client to the departure of a group of lawyers, even to weathering a recession.

In each instance, there is a lot to be said for maintaining some sort of capital cushion to help the firm get past the difficulty. Take the loss of the key client, for example, which can have significant ramifications for the firm's operations. While it is likely that the collections from the client will not dry up immediately, the firm needs to be prepared for reduced revenue in the future.

Yet the firm's ongoing operating expenses may not shrink as much as revenues may decline. To ensure that the firm continues to meet its financial obligations, it can take on bank debt or, hopefully, fall back on a strong capital position.

Those firms that lose a major client and then take on bank debt to prop up operations are truly taking a gamble that they will be able to regenerate their business before the loan comes due.

The firm would be in a far **better position** if it had adequate capital to weather the storm and then, if business did not pick up, consider other alternatives free of unplanned bank debt.

Conclusion

Today, not only is it necessary for firms to have clearly established capital policies, it is also important to have an institutional understanding and support for the roles of capital and debt.

It has become apparent that law firms were taking on more debt than they had in the past. This is due partly to strategic growth initiatives and partly to a reaction to reduced productivity.

A few firms have gotten themselves into trouble by borrowing far too much money and then using it to support partner compensation. We have seen the nasty backlash of such actions before and may see more within the next year or so.

Too often, we have seen thinly capitalized firms kick themselves for not being able to capitalize on (read afford) an acquisition opportunity and finance the operations by taking on additional bank debt.

It is such firms that worry us most. After all, at some point in the future, these firms will need to repay their "acquisition" debt. Unlike the repayment of debt used to purchase fixed assets (which should amortize relatively consistently and be cash flow-neutral), the only way to repay acquisition debt is by reducing partner distributions.

In more than one firm, such reductions--perhaps combined with an under-performing lateral group--have created internal dissent and second-guessing of the acquisition.

In contrast, the firm that is better capitalized can usually take on the lateral group with little, if any, additional debt - thereby eliminating the need to reduce partner distributions in the future.

Quite simply, the better-capitalized firm plans not only for what it anticipates in the short term, but also for what it cannot anticipate.