Doubling Down for Growth

By Edwin B. Reeser

We have talked about a fictional partner Mary Doe in a fictional large law firm, and the pressures she is facing with her practice and considerations of future economic pressure and career opportunity. We also looked closely at her capital account position in the firm and how it evolved. Now we are going to look at what is happening with the capital accounts in the firm from the perspective of the management.

The 10 partners who were de-equitized but retained in the firm received back all of their capital immediately, a typical arrangement as they did not leave the firm. This amounted to about $2.5 million of cash payments from the firm, a lower per capita average, as they were among the lower producing equity partners and already earning lower compensation figures. They have business ranging from as low as $400,000 to just under $1 million per year. Their salaries are reduced to fairly reflect what management believes is their contribution to the firm. The difference now is that they are effectively salaried employees at will. The good news is that they no longer have capital at risk, they get 100 percent of their salary in 12 equal monthly distributions, and it actually winds up costing the firm $1.7 million more in cash through the year to fund that compensation package as compared to when 45 percent was withheld from them as equity partners. But this increases the firm's profits per partner figures reported to the *American Lawyer* without increasing the gross revenue to the firm.

FOURTH IN A FIVE PART SERIES

This series explores some of the current illusions and realities of partner capital and capital accounts treatment in some large law firms. It is intended to be illustrative of issues and does not present the profile of any specific individual firm, past or present.

As noted, 40 more partners departed, and the combined capital accounts of those partners amounted to $15 million. However, only $5 million cash was paid out currently. The remaining $10 million is carried as a liability on the balance sheet. Twenty-eight partners have joined the firm, with a collective capital infusion of about $10 million. Netting out the amounts, the firm has paid out $7.5 million, taken in $10 million, and retained $2.5 million of cash, against an increased liability of $10 million. Next year, this liability will generate a $5 million payout, and the same the following year.

In addition, those 28 partners accrued recruitment commissions of $5 million, which were paid in full. However, those were "capitalized" and given a three-year amortization period, so that $1.66 million was expensed and $3.33 million carried as a liability. In addition, the firm is "fronting" the pipeline expense of paying the new partners, and their associates and staff for the better part of 90 days — before there is any stabilization of cash flow from the matters they have brought. This amounts to another $5 million cash outlay, which is also capitalized with a three-year amortization period. Taken together, this pipeline and commission eliminate the $2.5 million of surplus capital raised from new partners in the first year, and consume another $1 million of cash, to which is added the $10 million of out of pocket commissions and pipeline advances.

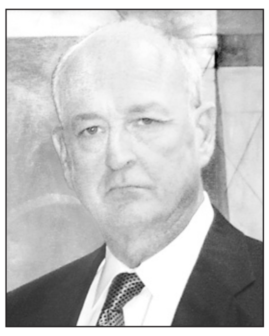
If you look at the dynamic, the new partners basically finance their own recruiter commission and pipeline period of 90 days with their capital account on joining the firm. Then, the cash they have contributed is gone! They each put in hundreds of thousands of dollars of capital, that is then distributed currently, with a future expense burden from amortization. The departing partners are financing the return of their capital with the collection of their accounts receivable. Using this technique, however, the departing partners collect their money in 90 days, paid in one-third increments over two years. This serves to increase distributable cash and reported revenue for the firm currently, but with a future nondeductible cash outlay burden for the unreturned partner capital. One could change the analysis and interpret this as new partners paying the old partners, or one set of capital replacing another, but that is not how the money is actually flowing and not how it is being treated on the books. I suggest we *look* at the money flow and *then* make the call.

The monies collected by the firm on the departing partner accounts receivable are income, without the departed partners having a distributable share as income since they are no longer partners of the firm. So there should be another cash flow "pipeline" as they leave from which the firm receives an increased income benefit. And it does, immediately in the months following departure. But not so over the next two years when the firm has to pay back the departed partners' capital. So what happens when you have a "frictional" or transactional cost of paying several millions of dollars of recruiter fees and capital returns to stay at or about the same size? The firm is beating up its financial statement with a sledgehammer, *paying millions of dollars to stay in the same place.* Income is artificially inflated: cash is taken in from the new partners not as income but as capital, and distributed to the partners in the firm, at the cost of carrying a significant liability to be paid off in future years from future year collections. Simultaneously, income is taken from the collection of departing partner accounts receivable while adding more term liability for the balance of their capital accounts. And of course, if the firm basically "runs in place" for three years with significant lateral hires and departures cancelling each other out, a big "bubble" of balance sheet liability to pay to departing partners has built up, while operating income (and thus profits per partner) has been inflated.

Assuming that the partnership had net zero change in its equity partner numbers, but in the other two years had 40 departures and 40 additions at roughly equal capital balances, by the third year the firm would be carrying an annual current obligation of $15 million of deferred capital returns payments to departed partners, with another $10 million due the following year and $5 million the year after, assuming this process was immediately halted "cold turkey." But if partners keep departing, then the capital outlay requirement continues without an offset from new arriving partners. Thirty million dollars of nondeductible capital returns is a lot of after tax income to redirect for this purpose.

Consequently, the departing partners are effectively providing interest-free financing to the firm, as unsecured lenders. And that capital return to them is not a deductible expense to the firm. So where is that cash money going to come from?

The money has to come from cash that is borrowed from a bank; contributed as increased capital from existing partners; contributed from capital due to growth of the number of equity partners in the firm; or earned by partners, taxed to them, and applied to the obligation rather than distributed to the partners. (This fourth and last option is unpopular with partners as they are paying taxes on money they do not receive, but it does not adversely impact reported profits per partner.) Only the third option above is truly attractive, as all others increase liability, or cause commitment of after tax income from partners.



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