Why firms go down the money hole

By Edwin B. Reeser

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After the financial trauma of 2008, the confidence of partners in the viability of firms needed reinforcement. Partners look to personal distributions as the measure of success and stability of their firms, so maintaining and increasing those is a management focus. With declining revenues and increasing costs, that's difficult. Firms can quickly descend into over distributing cash relative to actual earned income.

Recent failures have shown us that law firms typically borrow for one of four reasons. Two can be, but are not always, supportable; one is supportable if limited to being a short term reserve; and one is *never* supportable.

Capital spending for organic growth: Business is expanding, so the firm borrows to open a new office or hire people. The borrowing may be from a bank or from the existing partners.

Capital spending for lateral growth: The firm borrows to purchase an existing cash flow or stream of income. Specifically, lateral candidates who bring business. This can be individual lawyers, group acquisitions, or takeovers.

Cash flow support for operations: Covering liquidity shortfalls with short-term borrowing. (This must be distinguished from paying partner distributions when there is inadequate cash to do so, as that is accelerating the timing of receipt of cash from outstanding accounts receivable by drawing from the bank, then repaying the loan when clients later pay.)

Financial engineering: Characterizing items of expense as capital investment to overstate earnings, then distributing cash to partners as "profits."

Let's look at these in more detail.

Organic growth

Growth from within stems from increased demand for services. There is more money to be made if only the firm can meet demand. Adding attorneys and support staff, renting more space, buying more computers, etc., means the firm must invest in the cost of producing that income. Investment means the partners will take a reduction in their income until the operating margin or profit on the new work is collected.

Often it is an associate hire, the incremental cost is modest, and the recovery period is short. When a partner rises from within, the immediate additional cost is relatively little. The partner has been around for years, has a stable performance, and has been returning a margin of profit. There may be some need to buy additional equipment or space, but much of that will have already been done as the partner's proven performance has led to the addition of supporting attorneys and staff.

Organic growth puts a practical restriction on the rate at which a law firm may grow, as the talent development process consumes years of training and produces a small number of qualified candidates. It is also difficult to branch into new fields, as the expertise and training are not internally available.

Organic growth is a product of successful *business you already have.*

Lateral Growth

This is when a partner is imported. The immediate cost is significant. If a recruiter is used, a fee is paid — usually around 20 percent of first year compensation. In addition, the partner will have a pipeline period in which all costs must be paid by the firm before she can generate fee receipts. Ninety days is a fair benchmark.

New equipment and other capital items may need to be purchased. If a firm has an operating margin of 35 percent on fees to be received, that means that the firm must invest about 65 percent of the projected fees to be received on the new work, plus capital improvements, plus advances for client reimbursable costs — typically about 10 percent of fees billed — all before the work flows positive. Only then can there be recovery.

The payback can take years. This puts a practical restriction on the rate firms can grow from laterals, derived from the amount partners will accept as a reduction in current income for an expected return from a future increase in profits. Any scenario in which the lateral does not repay the costs and contribute a surplus to the firm will diminish income to the rest of the partners.

That is no longer a strategic hire; it's a bad deal for the firm, and often for the lateral. Borrower firms should calculate the present value of a profit stream, and if it is sufficiently higher than the cost of the capital required to acquire and own it, the transaction may make sense.

The lateral hire decision is also influenced by the time it takes to recover invested monies. More senior partners approaching retirement may hesitate to invest if their tenure with the firm may not be long enough to receive a return.

A firm in a continuing long term growth trajectory requires the partners to constantly invest, through reduced distributions of income to themselves. Many larger firms, until the early 1980s, relied almost exclusively on internal growth without bank borrowing. The accumulated partner investment can be measured by looking at the operating margin of the firm. Multiply that times the collectible accounts receivable and work in process to get the cumulative investment unreturned to the partners.

Lateral growth is a product of searching for successful *business you do not have*, with an uncertain outcome.

Cash Flow Support

This starts with small revolver loans, lines of credit to "smooth out" irregularities. Conservative firms only distribute monies to partners when monies are received, and maintain cash reserves large enough to carry operations through slower periods, so only small borrowings are required.

It is incumbent on each individual partner to exercise personal financial discipline. Eventually, firms tried to level out distributions to partners with a scheduled payout, which were draws against forecast income calculated at the start of each new fiscal year. This made some sense because partners could prepare their own personal budgets to live within. These schedules often worked as a percentage of the full year forecast income, both to be fiscally conservative if unexpected down cycles in collections occur, and to avoid borrowing from lenders. Remember, until the mid-1990s law firms were general partnerships and many partners were loath to be jointly and severally liable for such borrowings.

To grow, firms adopting the above draw model could borrow from the accounts receivable and pay for the growth from current collections, masking the true impact to cash flow by filling the gap with borrowings. This is dangerous, because if collections performance disappoints, the impact to the reported profits can be significant.

In a year of disappointing earnings, borrowing to fund partner draws can put *extreme pressure on management to adopt the fourth type of borrowing.*

Financial Engineering

This is a self-destructive cannibalization of the enterprise. Easy to do and wickedly difficult to detect, tweaks to the modified cash basis accounting books can generate millions of dollars of profits with pencil strokes.

With financial engineering, we see artificially increased reporting of profits, and thus enabled distributions that the firm cannot afford. This causes a net increase in debt and often a greater concentration of ownership in fewer partners. The higher the debt levels and ownership concentration, the greater the system's fragility. Ultimately, a liquidity crisis surfaces, and the firm collapses quickly.

Equity contributions from partners are functionally a form of debt, so the distinction of supporting the firm with large partner contributions rather than bank debt is not meaningful. Infusions from partners, especially the middle and lower classes not privy to what is going on, can occur when the banks are unwilling to lend more themselves. Indeed, it is often evidenced by large individual partner loans from banks, so the debt is either owed by the firm to the partner, or as a pass through from the bank that lends to that partner.

Any dressing up of the books with financial engineering is a red flag, which is why it is more likely to occur in firms where access to the books is denied to partners. *There is never an excuse for it.*

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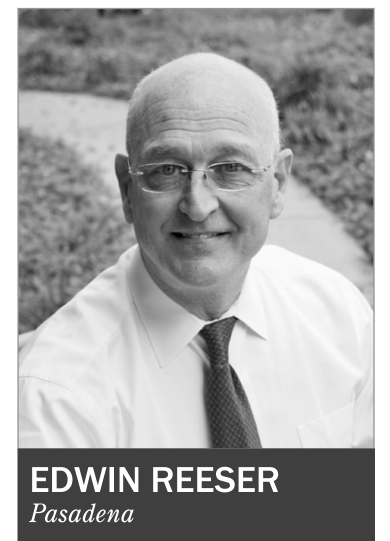
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Reform long overdue for state conservatorship process

By Thomas F. Coleman

The conservatorship process for adults with developmental disabilities is broken. There are about 40,000 such adults currently in conservatorships in California, and about 5,000 new cases are added to the system each year. There are many systemic and operational problems with the processing of these cases.

It's not too soon to get the number crunchers into the conversation about "supported decision-making" and guardianship reform. The best laid plans by policy people and rights advocates never gain real traction without also having financial analysts in the mix too.

Proponents of supported decision-making have been focusing on issues of self-determination and equal rights for people with intellectual and developmental disabilities. The idea is that, with proper support, people with disabilities have the capacity to make their own decisions without guardianships.

Those proposing reform of adult guardianships for people with developmental disabilities, known in California as limited conservatorships, have been complaining that the system has structural flaws and operational deficiencies of a magnitude that violate constitutional guarantees and statutory requirements.

The conversations about supported decision-making and guardianship reform are now moving from academic discussions and idealistic dialogues among like-minded individuals into the realm of politics, which adds another set of considerations.

The Disability and Abuse Project has been in contact with the Judicial Council of California — the state agency that makes rules, develops forms, and provides education to judges and attorneys. That agency is only now realizing the seriousness of the many problems existing within the limited conservatorship system.

To address these problems, the Judicial Council has designated two advisory committees to work with its educational institute to discuss possible training programs for the judges and attorneys who process limited conservatorship cases. This approach is like painting an airplane that has major mechanical problems. In the end, the plane looks nice, but the unfixed defects continue to place passengers at risk.

Proponents of supported decision-making and conservatorship reform should insist that defective parts be replaced and that periodic inspections be done by trained mechanics. Pilots and navigators also need to receive training, plus the entire team must be accountable to someone.

Without systemic changes in policies and procedures, and without ongoing supervision and routine monitoring, the educational programs under discussion by the Judicial Council will be little more than cosmetic.

Budget planners need to have a seat at the table along with judicial overseers. Reform advocates also need to be involved in the process of creating what should be meaningful and lasting reform. Ongoing discussions and planning should be inclusive and transparent.

Evaluating supported decision-making as a less restrictive alternative in thousands of individual cases will cost money. So will the processing of conservatorship cases if supported decision-making is not adequate to protect vulnerable adults.

Insuring that proposed conservatees receive equal access to justice — as required by the Americans with Disabilities Act and by the Fourteenth Amendment — will cost money, too.

Budgets will need to be increased for agencies that play or should play a role in the limited conservatorship system. At the state level, that would include the Judicial Council, the Department of Developmental Services, and the system of regional centers, as well as the federally funded Disability Rights California.

At the local level, superior courts that employ judges and investigators will be financially affected. County governments pay the fees of court-appointed attorneys and public defenders. So room should be made at the table for presiding judges and county supervisors.

There will come a time for educational programs — but only *after* decisions have been made about systemic changes and their estimated costs. First things first.

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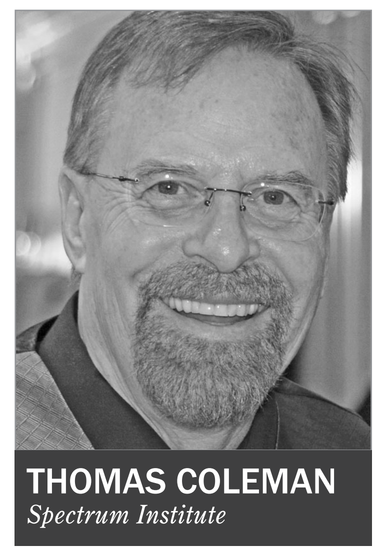
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