Do you know if your firm is sinking?

By Edwin B. Reeser

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Law firm failures often catch partners by surprise. So can you make an informed evaluation of how your firm is doing? There are metrics which help, and you needn't be an analyst to use them. These aren't profits per equity partner (PPEP) and revenue per lawyer (RPL), typically associated with measuring performance.

Lawyers are buried in PPEP and RPL figures, yet we know those are susceptible to manipulation. Before its demise, Dewey & LeBoeuf LLP reported PPEP and RPL in a fashion that compelled The American Lawyer to lower them in an annual financial performance survey. But PPEP and RPL didn't indicate the firm was facing extinction.

Simplicity and clarity in numbers is compelling, but it's dangerous if you don't know how to interpret those numbers, understanding what they do and *do not* mean.

Begin with three basic metrics, known as "liquidity ratios" — because law firms do not fail because they have inadequate profits; they fail because they have inadequate *cash*. Think of yourself as being saddled on a rocket with two gauges. One (PPEP) measures profits, how fast you are going. The other (liquidity) measures cash flow, the fuel mixture that indicates whether you might explode. Which is more important?

For recent law firm failures, these ratios provided warning signs well in advance of collapse. A full financial analysis goes further, but we start with what may be the most critical. Liquidity ratios help evaluate a firm's ability to meet short term obligations; the inability to do so is the very definition of insolvency. All you need is a summary balance sheet and income statement of the firm. As an equity partner, you should have these already.

Working Capital Ratio

This is the ratio of total current assets to total current liabilities. Working capital is the excess of current assets over current liabilities. The "WCR" typically delivers a number that is "*x* number of times" liabilities. The computation can be made at the close of each accounting period for a dynamic picture of the firm's liquidity over time.

Let's assume a hypothetical firm with $100 million in annual fees and 36 percent "profit." The firm has an office lease, and no debt except a revolving credit line from the bank.

Current assets equal cash plus average accounts receivable. Work in process (WIP) is not billed yet and, with unpredictable conversion to accounts receivable, won't be included. For this example, we'll set the sum at 3.5 months of fees, about $30 million.

Current liabilities include everything paid on a current basis, such as salaries, rent and operating expenses. The operating expenses of this firm are $5 million per month. If we stop here, WCR is "6 times" liabilities ($30M / $5M). That sounds pretty good — if you don't plan on *paying partners*. This firm has a 55 percent draw on forecast annual profits, paid monthly, which adds $1.65 million — for a monthly burden of $6.65 million. The WCR falls to 4.5 times. That is less good, and it is going to fall further.

First, remember that no one metric can be relied upon as a measure of success or failure. Law firms typically don't show a stronger fiscal year end WCR because while year-end collections are strong, the increase in cash is offset by the reduction in receivables from which they were collected. A few weeks into January, the firm distributes cash to partners for prior year income shares. That removes the asset from the balance sheet, causing the WCR to fall. In our example it will be $17 million, reducing the current asset base to about $13 million and the WCR to 1.9 times. This presents a radically different snapshot than just one month prior.

Second, our hypothetical law firm has a not unusual collections pattern of 15 percent in Q1, 20 percent in Q2, 25 percent in Q3, and 40 percent in Q4 which must be addressed.

Q1 collections are 60 percent of the level monthly collections ($8.33 million for $100 million annual collections), only $5 million. Monthly outflow of $6.65 million generates $4.95 million in Q1 negative cash flow. Partner draws for the first three months of the year are $4.95 million. The firm is cash flow negative. Where does the extra money come from?

Q2 collections are 80 percent — a $6.67 million inflow against $6.65 million outflow. The Q2 has stabilized to a neutral position, but Q1 + Q2 cumulative cash flow remains negative.

Q3 collections are level with the annualized average, and positive cash flow returns. In our example, the firm recoups the aggregate negative cash flow of $4.95 million ($8.33M - $6.65M = $1.68M) at the rate of $1.68 million per month. By the end of Q3 that is $5.04 million. For this example the firm has worked its way back to a parity of having earned and distributed the partner draws to date. The last quarter puts the collections pressure to not only cover expenses and draws, but the remainder of 45 percent of forecast net income. That is pressure!

Reviewing the firm's WCR over a term of several years helps to identify areas of concern. Is the WCR worsening over time, gradually getting lower? Is the firm borrowing more money in Q1 of each year? Is the firm repaying that bank loan off later and later each year? Is the firm deferring expenses more often? That payables pile will increase the WCR denominator.

What does using a working line of credit to pay partner distributions really mean? Apply all cash on the balance sheet to offset debt. If debt balance remains, then the firm is borrowing against the future collection of accounts receivable to make current distributions to partners — possibly even pay operating costs. This highlights how cash flow can be under severe pressure, and shows how much the firm may be relying on deferring expenses, using short term debt, or even those "start of the year new capital contributions" to fund partner draws — *with the partners' own money!*

Acid Test Ratio

This is a more conservative variation of WCR that limits the current asset numerator to cash and "net" receivables. For determining the "net" component, eliminate all fee matters not expected to be collected within 90 days, and remove all problem receivables under 90 days aging. Liabilities are the same as before. The "ATR" removes receivables with uncertain collectability so you deal with what you *know* you will get. If you can't get that data, simplify and apply the historic realization rate.

Defensive Interval Ratio

The "DIR" uses the same numerator as the ATR, then divides it by projected daily operating expenses, including partner draws. This measures how many days the firm can operate on its present liquid asset base without resorting to additional debt or capital infusion/revenues from next year.

Each of these three simple tools provide a slightly different view into the liquidity of the firm. No one tool is necessarily better, but the collection of perspectives is valuable as one ratio might suggest a weakness and another will reflect a strength otherwise not apparent.

Law firms are service companies deriving revenue from labor, paid for in advance, which comprises about two-thirds of total costs. The cost of that labor has to be considered in evaluating the financial strength of the enterprise. This is particularly so when the units of production have the freedom to pick up and leave with the revenue streams from their clients. It is important to use and understand these and other simple metrics, like most businesses do, because they can tell you how your business is *really* performing — not how it compares to some other business on a flexing yardstick.

Finally, a few questions to consider: When the financial performance of the firm overall lags relative to the rewards paid to the leaders and managers, might the partnership have a problem? Over the last 10 years, how much has compensation of the managing partner increased relative to the increase in compensation of the average partner? Would the trend of firm liquidity over that period be a metric that might have significance? How has the firm been funding growth and partner draws over time, and has the use of debt and equity contributions increased? Does that seem like a responsible management decision to you?

Next time we explore a few more metrics for your "tool chest."

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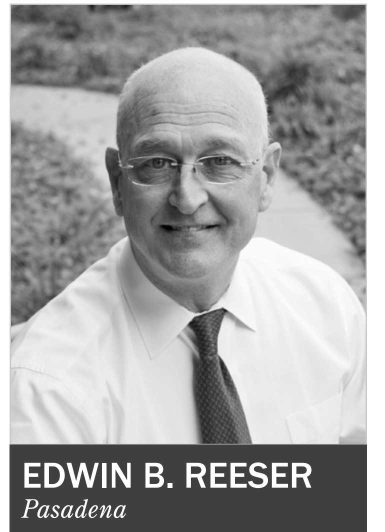

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Allowing patent eligibility tests at the pleading stage

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the "inventive concept" analysis articulated in *Mayo Collaborative Services v. Prometheus Laboratories Inc.* to conclude that the claims did not add "significantly more" to the abstract idea to be patent-eligible. In *Bilski*, *Mayo* and *Alice*, the court held that some of the claims at issue were ineligible, and in doing so consistently referred to Section 101 as a "threshold test" (*Bilski*), which performs a "screening function" (*Mayo*) in order to weed out ineligible patents.

The question remains after *Alice* whether Section 101 is properly adjudicated at the outset of the case, in a pleadings challenge before a defendant is forced into expensive civil discovery. (*Alice* and *Mayo* were both decided on summary judgment, and *Bilski* was an appeal from the Patent and Trademark Office.) Early resolution of Section 101 challenges can save litigants and the judiciary significant time and resources, as a successful pleadings challenge obviates the need for expensive discovery and complicated summary judgment motions on more fact-intensive validity issues.

As the Supreme Court explained in *Bell Atlantic Corp. v. Twombly*, a complaint must include enough facts to make it plausible — not merely possible — that the plaintiff will be able to prove facts to support its claims. The deficiency of a claim should "be exposed at the point of *minimum expenditure of time and money* by the parties and the court." *Twombly*'s requirement of specificity helps "avoid the potentially enormous expense of discovery in cases with no 'reasonably founded hope that the [discovery] process will reveal relevant evidence'" to support a claim. Simply put, a plaintiff fails to state a claim when allegations are premised on a false or implausible legal theory under which a plaintiff is not entitled to relief.

A challenge to the eligibility of a patent under Section 101 fails out of the gate for precisely these reasons. Section 101 eligibility is a *legal* question, and a patentee asserting an ineligible patent is no different from an antitrust plaintiff advancing a legal theory that is not cognizable. These claims are barred as a matter of law and warrant dismissal.

A decision pending before the U.S. Court of Appeals for the Federal Circuit, *Ultramercial v. WildTangent*, will allow the court to decide whether Section 101 challenges may be raised on the pleadings. The claims at issue in *Ultramercial* cover methods for allowing Internet users to view copyrighted material free of charge in exchange for watching certain advertisements. Because the *Ultramercial* patent claimed an age-old method of advertising, the district court dismissed these claims as ineligible. (*Ultramercial* has been up to the Supreme Court twice — the case was remanded without briefing following *Mayo* and again following *Alice*.)

The Federal Circuit initially reversed the district court, without mentioning whether the eligibility determination was proper at the pleadings stage. Then, on remand from *Mayo*, and without hearing oral argument, the court again held the claims eligible under Section 101, but this time noted in dictum that Section 101 dismissals on the pleadings will normally be "improper." The court explained that because a challenger must overcome the presumption of validity afforded to issued patents, "the *only* plausible reading of the patent must be that there is clear and convincing evidence of ineligibility." The court also remarked that the Section 101 analysis will typically be "rife with underlying factual issues," and that as a result, Rule 12(b)(6) dismissals under Section 101 "will be the exception, not the rule."

The Federal Circuit's criticism of Section 101 challenges at the pleadings stage is inconsistent with Supreme Court jurisprudence, as well as the high court's standard for adjudication under Rule 12(b)(6).

For instance, the *Ultramercial* court held that patents are "presumed" valid, and that because this presumption can be overcome only by clear and convincing evidence, the pleadings themselves are normally insufficient. But this presumption does not apply to Section 101 challenges. The Supreme Court in *Microsoft v. i4i* held that *invalidity* defenses must be proved by clear and convincing evidence, but Section 101 governs patent "eligibility," not "validity." Section 282 of the Patent Act defines the "validity" challenges (included in Title II), and Section 101 "eligibility" (in Title I) is not included. If a patent does not even recite eligible subject matter, it is not presumed valid.

In addition, because Section 101 is a legal question, it is not governed by evidentiary presumptions. As Justice Stephen Breyer explained in his *i4i* concurrence, "[w]here the ultimate question of patent validity turns on ... what these subsidiary legal standards mean or how they apply to the facts as given — today's strict standard of proof has no application."

In determining whether a patent claims an abstract idea, the world of relevant facts should exist within the four corners of the patent. The two fundamental Section 101 questions that courts must answer under *Alice* — are the claims directed to a patent-ineligible concept, and if so, do the elements "transform the nature of the claim" into a patent-eligible application — are firmly rooted in the claim language, the construction of which is a legal, not factual, matter. Courts at the pleadings stage may choose to construe the claims, or to adopt (for purposes of the motion to dismiss) a plausible construction proffered by the patentee. But there is no reason to think that Section 101 determinations are *always* or even *usually* "rife with underlying factual issues" as the *Ultramercial* panel presumed. To the contrary, the Supreme Court's recent Section 101 cases have focused on the operative patent claims, which the court in each case has reviewed de novo without any deference to findings or conclusions below. Numerous district courts before *Ultramercial*'s unfortunate dictum had decided Section 101 challenges on the pleadings.

The *Ultramercial* panel's decision is infected with the same underlying error the Supreme Court rejected in *Alice*. The Federal Circuit in *Ultramercial* held that the claimed invention at issue was patent-eligible because it "is not *'so manifestly abstract'* as to override the statutory language of section 101." But the Supreme Court in *Alice* unanimously rejected the "manifest" abstractness standard, and because this heightened burden undergirds the basis for the *Ultramercial* panel's distaste for pleadings challenges, the court on remand should jettison its earlier view.

If a patent defendant can show that even under the plaintiff's (plausible) reading of the patent it recites an invention that cannot plausibly add "significantly more" to an abstract idea, then the defendant should succeed on a 12(b)(6) motion. There is not a different rule under the patent laws, as the Supreme Court (for example, in *eBay v. MerkExchange* and *Medtronic v. Mirowski*) has repeatedly stressed.

There are enormous costs to eliminating Section 101 as a screening mechanism at the motion to dismiss stage. Much of the harm from low-quality patents takes the form of litigation expenses and nuisance settlements for the cost of litigation. Deferring Section 101 challenges until after the parties go through expensive discovery would not only prevent eligibility from being a "threshold test" as the Supreme Court has required, but would also further drive up the cost of patent litigation and provide incentives for unmeritorious patent claims. The Federal Circuit should therefore encourage, not limit, the availability of Section 101 challenges early in litigation.

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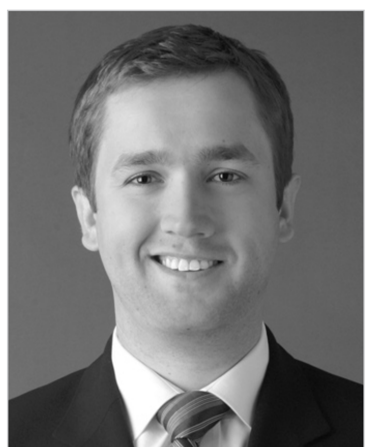

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