Lending to Law Firms

by Edward L. Cooper III

Five key elements underlie successful loans: business strategy; financial strategy; purpose of the credit facility; issues affecting repayment sources; and structural elements to protect secondary exit strategy. This article reviews those elements as they apply to law firms.

Q: What’s the problem with lawyer jokes?
A: Lawyers don’t think they’re funny, and no one else thinks they’re jokes.

There’s no lack of jokes about lawyers. But lending to law firms is no laughing matter, as the primary assets of these credits leave the office every night. If we bear in mind the fundamental principles of underwriting credit, this sector of the service economy offers strong opportunities for long-lasting and profitable relationships. So let’s review the key elements of successful lending as they apply to law firms.

Firm Business Strategy

Law firms are for-profit entities; thus, their business strategy should state how they intend to meet profit objectives. Typically, law firms discuss their strategies through use of marketing materials that discuss their practice areas, geographical locations, and services offered. Often lacking are clearly defined goals, value propositions, and business development plans for meeting profit objectives.

Financial Strategy

A law firm’s financial strategy should be consistent with its business strategy. The retention of capital required for growth typi-

Strategic issues that law firms need to consider include firm composition, the partner-to associate ratio, the level of equity partners to non-equity partners, methods of earnings distribution, succession planning for future leadership, and retirement of senior partners.

In lieu of a written document, a discussion with a few of the firm’s senior equity partners can shed light on the consistency of the firm’s strategy.
ally competes with the desire to make partner distributions. The methodology for determining year-end payouts should be based on a cash accounting basis. The funding of long-term liabilities, such as lease commitments and retirement obligations, must be considered in a financial strategy. Capital needs for technology upgrades—hardware and software—should be identified and clearly planned.

**Purpose**

Most law firm credit requests fall into three categories: 1) working capital; 2) support of office leases; and 3) equipment, technology, and leasehold improvement purchases.

Working capital is a primary seasonal need for law firms. Unless a retainer is received in advance, the firm will have to pay out-of-pocket for operating expenses (associate salaries and utilities) related to client matters prior to billing and collecting. Certain types of clients—for example, insurance defense firms—have periodic billing cycles in which fees are paid quarterly. This need is typically seasonal, as the collection of accounts receivable by bonus payout date provides cash sufficient to retire any working capital debt.

Letters of credit may be required to support the firm’s lease obligations. These amounts typically represent one year’s lease payments. As the firm establishes a payment history with its landlord, the level of support can be reduced and often eliminated. As is typical in all credits, letter of credit amounts should be reserved against the collateral position.

Equipment, technology, and leasehold improvement represent intermediate lending opportunities. As is typical of these asset classes, a lender must be comfortable with the firm’s intermediate cash flow. Repayment from this form of collateral is limited at best.

**Issues Affecting Repayment**

The number-one repayment source for just about all credits is cash flow from earnings. This expectation should also ring true for law firms. However, earnings often are reduced by year-end distributions. These distributions are made to minimize the firm’s tax obligation. It is important to acknowledge that the tax obligation is not eliminated, just deferred. At a future date this obligation may need to be satisfied, a situation that may slowly create a permanent level of debt capital that must be addressed.

The following are features that may affect the primary repayment source:

- **Concentrations.** The loss of a meaningful client or the reduction of a specific type of service (IPO and bankruptcy services), due to cyclical downturn, can have devastating effects on cash flow.
- **Stability of key employees.** It is important to understand who the firm’s top billing partners are and how they are compensated. Gone are the days when high-billing associates waited their turn to share in the profits.
- **Flexibility of overhead.** Should revenues decline, will the firm be able to reduce overhead? Is it willing and able to reduce staff levels? Is overhead (lease payments, retirement payouts, term debt payments) flexible? Are there meaningful capital additions required for technology improvements?
- **Shift in strategy.** Significant commitment to a geographic expansion, the addition of new practice areas, new office space, and additional associates all add to cash flow requirements.

**Protecting the Secondary Exit**

As mentioned at the outset, highly specialized service firms are unique in that their assets leave the office every night. As the assets go, so does the ability to generate cash flow from earnings. Depending on the size and diversity of the firm, some or all of the following structural elements may assist in preserving a secondary exit.

- A borrowing base for working capital facilities, including a review of the accounts receivable aging and realization rate (similar to dilution, the amount collected as a percentage of the amount billed).
- Collateral, primarily the accounts receivable.
- Cash flow control through maintaining the depository relationship.
- A limit placed on the length of the facility.
• An annual cleanup requirement.
• Guarantees from the partners.
• Regular reporting requirements, including accrual and cash basis financial statements.
• Covenants concerning a minimum level of partners and a minimum level of accrual-based equity.
• The ability to limit partner distributions if covenants are not met.

Conclusion
A clear understanding of the purpose and repayment of the credit facility, combined with consistent affirmation of the firm’s strategy, should prevent lenders from being surprised by law firm credits. Because cash flow is the dominant repayment source, the ability of the firm to meet its strategic goals and continue as a going concern is of prime importance.

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