

# Getting 'real' about law firm balance sheets

By Ed Reeser

Notwithstanding the absence of bank debt, a large law firm can still collapse under a structure of extreme financial leverage. The message "We have no debt" is not the same as "We have no financial risk," though that is how the message is normally received, and probably meant to be received.

## FIRST IN A TWO PART SERIES

The debt/equity entries on the right side of the balance sheet match up to the assets on the left side. Understanding how those simple elements interrelate leads to questions, and the answers can reveal significant insights to firm financial strength and stability.

Let's do a simple illustration. Assume that the top right side of the balance sheet is "zero" for bank debt, and the bottom right is your firm equity capital. That means all of the top right side is current accounts payable, and perhaps current period lease obligations. Theoretically by paying all obligations instantly when due, there is no current liability.

Now, turn to the left side of your balance sheet, which is all assets.

For a law firm, assets will be what, precisely? No goodwill, most large law firm partnership agreements abolish it, for a variety of well intended and justifiable reasons. That leaves cash, accounts receivable, furnishings, fixtures and equipment, inventories, and supplies. Paid-in capital is reflected in the noncash items, if the firm owns them, but the lion's share is always accounts receivable. That looks pretty great, doesn't it? Cash, solid receivables, equipment and furnishings, no "debt" and oodles of capital. That is what the typical person hears when they are told "we have no debt."

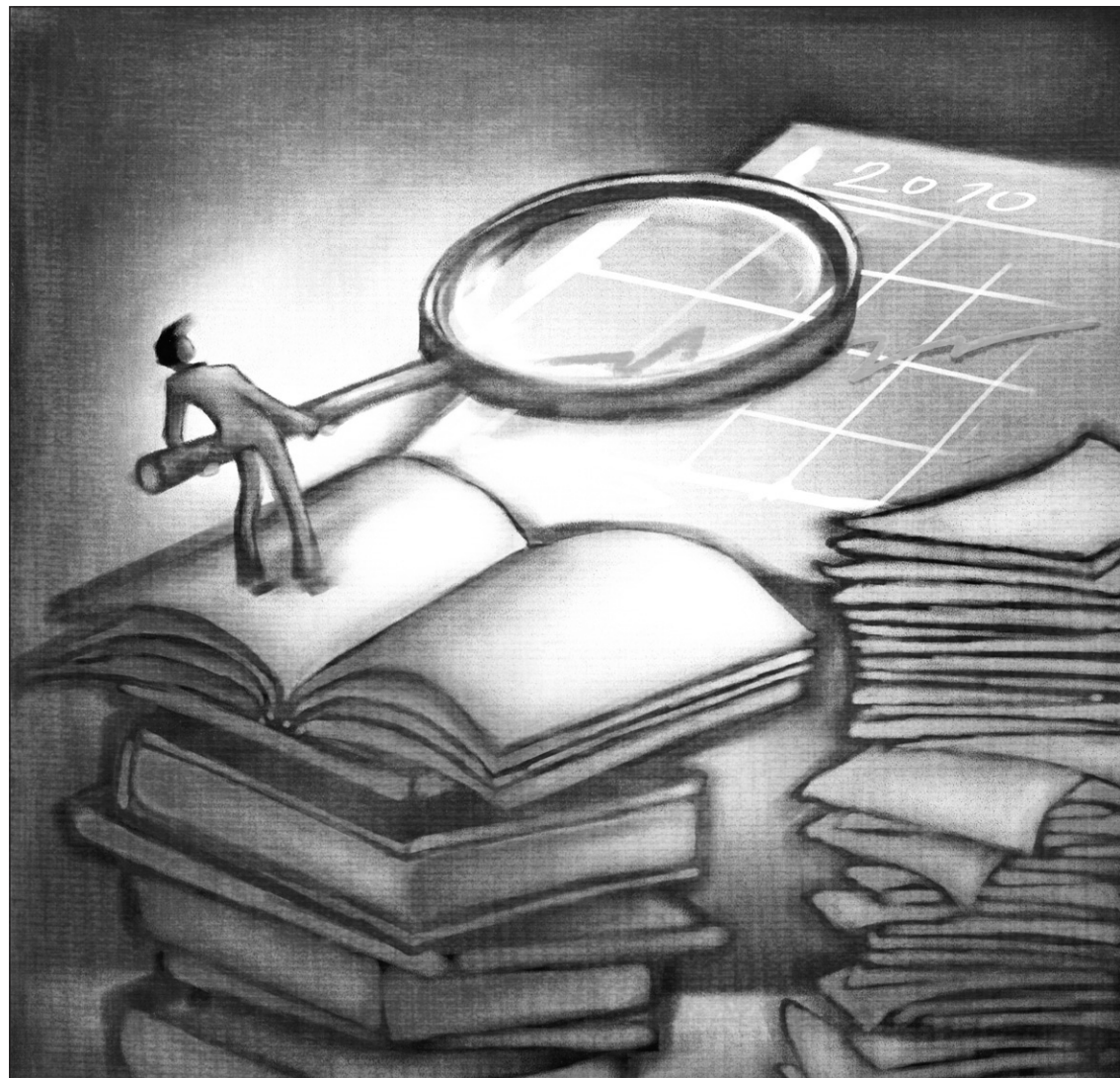
But now, let's get real. All of that stuff other than cash and receivables is amortized. As an amortizing asset is "wasted" or depreciates, the equity side of the balance sheet should shrink too. Therefore, notwithstanding massively large individual capital requirements, the actual equity balance will not be that large. Every year as the collections come in, accounts receivable are reduced and cash goes up. The asset total as between them does not change in that period, just the relative percentages. The asset total goes up when the bills go out, increasing the receivables total. The

asset total goes down as cash is expended for salaries, operating costs, capital investments and, of course, partner distributions. Cash for expenses reduces assets on the left side of the balance sheet, and liabilities on the right side. Cash for capital investments reduces assets on the left side, but increases assets on the left side in the same amount. When distributions go to the partners, usually in large amounts in January, the cash distributions will dollar-for-dollar reduce the paid in capital. The official year-end balance sheet will overstate the actual financial health of the operation, because a lot of the equity will be the undistributed cash in the bank on Dec. 31. By Jan. 15 of the next year, that cash is distributed to the partners. Accounts receivable have been aggressively reduced by year end to obtain that cash, and the equity entry is decimated in a firm that distributes 40 percent or more of annual compensation to the partners. That is the better number to look at as the year begins anew — but partners rarely get a look at that one.

The critical problem in firms is not *undercapitalization*, whether sourced in equity or debt. It is *overdistribution*.

Are large items leased and not owned? Leasing is a type of borrowing, but it doesn't show up on the financials as "debt." For example, the firm has no bank loans, but the telephone system is leased, the computers and copiers are leased, the furnishings are leased. Huge monthly payments are committed over perhaps a five-year term, or longer. Lawyers may use the term "no debt," but the reality is a liability of substance is still there — that leased equipment and personal property is 100 percent financing for many of those assets, assets with little or no residual value at the end of the lease term.

Real estate is a huge potential liability over a long term, and it is an increasing burden on operations when the timekeeper headcount starts to decline. Fixed overhead is placed on fewer shoulders, increasing the per capita current cost of occupancy for



those who remain. At some point of decline, it becomes unsupportable. To further complicate matters, leases tend to have favorable initial terms and front loaded concessions, bump increases at set terms such as every five years, occasionally a letter of credit as standby collateral security for recovery of over-standard leasehold improvements made by the landlord, occasionally "must take" commitments for additional space. It isn't debt, but it is a long-term contractual liability.

The critical problem in firms is not *undercapitalization*, whether sourced in equity or debt. It is *overdistribution*. Not having "bank debt" is largely irrelevant to this problem. Debt can make the ultimate collapse more expensive because of the claims of the creditor banks, but the collapse comes all the same from the simple problem that there is not enough cash generated by the enterprise to satisfy the distribution requirements of the lawyers who can leave, almost at will. A firm without debt can still consume itself until it collapses with *internal movements of capital* for the wrong purposes.

But those big accounts receivable, those may be a couple hundred million dollars. Isn't that protection? The answer is, only somewhat, and that assumes what is listed is all collectible. It has to be fed with a continuing production of new receivables as about a third of the receivables of a firm are consumed every month just to keep operations running. If work inflow starts to slow, or attorneys leave, thus resulting in lower generation of billings/receivables, and expenses are not immediately cut, then the receivables pool will begin to shrink. When that happens, working capital begins to shrink. Eventually operations may not generate sufficient cash funds to pay obligations on a current basis. Juggling priorities on where cash is applied becomes a challenge. Furthermore, irregular timing of receipts is critical. Firms tend to collect heavy in the last quarter, and anemically in the first quarter, putting the firm in a cash flow squeeze they need to recover from in the first half of every year. Where does the firm get the cash to do that if they don't borrow from a bank or make a capital call

on partners? Only a few choices: a huge cash reserve retained after partner distributions, a smaller draw for partners, or perhaps holdbacks or delays on distributions to others. Or making changes to accounting procedures previously applied that will give the appearance of better performance.

The firm can squeeze back on draws to pay out what they have when they have it, and not borrow from banks to make partner draws. But a firm can have problems doing that with employees, associates and income partners. Those folks get a salary. Normally with a small equity

partner pool, those equity partners are the only ones that get draws which can be deferred until "profits" are available for distribution. A firm with a huge leveraged pyramid of attorneys will have trouble doing this. A partnership with a thin operating margin and high costs might not reach true distributable "profit" until as late as September. We have seen some firms with robust margins still not reach a position to be generating net income for equity partner distributions until May, June, and sometimes July. Do the partners wait that long, living on savings and borrowing on personal lines of credit to cover living expenses? Isn't the "push down" of that aspect another form of borrowing — just administered at the personal level rather than the firm entity level? If a firm requires extra heavy capital from its partners, and they borrow it personally, isn't that just a push down of the entity borrowing need to the individual partner? A rose by any other name is still a rose. The stability of the enterprise is not necessarily enhanced with the structural location of where the debt is felt by the partners.

Capital can be from equity, or it can be from borrowings, or a combination from both. But all of it comes from the right side of the balance sheet. What matters is the ability of the enterprise to generate enough distributable cash on a sustainable basis to satisfy the partners, without compromising the capital base of the firm. A migration of capital from equity to debt on the right side of the balance sheet can be a sign of trouble, but not always. A large component of equity to debt can be a sign of strength, but not always. But a policy that permits distributions that are sourced from either equity capital or debt capital ultimately results in giving back to the partners their own money, and potentially bank borrowings as well. As we shall see in the next installment, what matters is how the capital is used.



Edwin B. Reeser is a business lawyer in Pasadena specializing in structuring, negotiating and documenting complex real estate and business transactions for international and domestic corporations and individuals. He has served on the executive committees and as an office managing partner of firms ranging from 25 to over 800 lawyers in size.

# High stakes in November election for the federal bench

Continued from page 1

I do think most judges take their jobs seriously and try to render justice based only on the law. As such, most judges would likely argue that their political party is irrelevant. However, I believe that each judge's life experience and world view, and inevitably their party affiliation, will give you a window into where they are coming from and where that likely will lead them.

Currently, the federal judiciary, like the country, is split down the middle with a slight Republican advantage. On the Supreme Court, there are five Republican appointed justices and four democratic appointed ones. At the circuit court level, there are 84 Republicans and 81 Democrats.

An Obama victory this November with Clinton winning in 2016 could mean that by 2021 more than 50 percent of the active district court positions were appointed by those two presidents alone.

In his first term, President Obama confirmed 30 circuit court judges. By contrast, in two terms, George W. Bush confirmed 62 and Bill Clinton confirmed 66. At the district court level, President Obama has confirmed 125 judges out of 677 positions. Thus, in one term, he appointed 18 percent of the federal judgeships. Assuming these numbers hold constant — though they may understate the potential number of appointees (George W. Bush appointed 261 and Clinton 305)

— an Obama victory this November with Clinton winning in 2016, could mean that by 2021 more than 50 percent of the active district court positions were appointed by those two presidents alone. Of course, because Obama's numbers may be a bit understated that number could be even higher. From 1981 to 1993, in the 12-year period when Ronald Reagan and George H.W. Bush were president, they appointed a combined 438 district court judges. During their tenure, they replaced over two-thirds of the judiciary.

The Supreme Court, however, is the biggest prize of all and luck has more to do with the composition of that court. For example, Chief Justice William Rehnquist, who died in 2005, could just as easily have been replaced by a President John Kerry if he had only been able to carry Ohio in 2004. Because there are only nine justices, one president can significantly affect the balance. Consider the recent example of the Obamacare where it was alleged in media reports that Chief Justice Roberts switched his vote due to his Epilepsy and the medication he takes for it. While we have no knowledge if this is true, assuming that it is, one person's life experience can have a widespread effect on the entire country. How often do the personality traits and quirks of the nine come into play to affect our jurisprudence? Unfortunately, we don't and can never really know.

Currently, the court can be divided up into a younger and older group. The young group, ordered by age and the president who appointed him or her, consists of: Elena Kagan (52, Obama), Chief Justice Roberts (57, George W. Bush), Sonia Sotomayor (58, Obama), Samuel Alito (62, George W. Bush), and Clarence Thomas (64, George H.W. Bush). These five, barring something strange happening, are unlikely to



The U.S. Supreme Court is seen on the eve of the Affordable Care Act decision in June. The November election could have an impact on the court's ideological make-up for years to come.

turnover in the next eight years.

The older justices break down as follows: Ruth Bader Ginsburg (79, Clinton), Antonin Scalia (76, Reagan), Anthony Kennedy (76, Reagan), and Stephen Breyer (74, Clinton). While each of these justices could serve through 2021, it's not likely. A Romney presidency could conceivably see both Scalia and Kennedy retirements. That would create a court with five Republican appointees under 70.

It was recently reported that former Supreme Court nominee Robert Bork is leading Romney's Justice Advisory Committee. This tells you something about Romney's judicial philosophy and the types of justices he intends to appoint — conservative justices who are strict constructionists. After the appointments of Justices Stevens and Souter — both fiascos from a Republican point of view — such mistakes will not be

made again.

Justice Ginsburg is a major liberal fear this election. She has had multiple bouts with cancer suffering from colon cancer in 1999 and a bout with pancreatic cancer more recently. While her life expectancy is 10 years, her health history likely reduces this somewhat. In a recent court appearance in April, I witnessed that she needed assistance walking to the bench. If Ginsburg were to die or retire during a Romney presidency that would flip the balance entirely. With the combination of Kennedy and Scalia retirements with a Ginsburg departure that would allow Romney to appoint three new justices. This would solidify the conservative's majority with six young votes. While Roberts is now supposedly a moderate, I hardly think so. On most issues, he goes right. The Affordable Care Act scenario was likely an anomaly.

Moreover, with a solid six-justice majority, the conservatives could lose a vote and still carry the day.

By contrast, a second term for Obama would probably mean maintenance of the status quo. Ginsburg has indicated a desire to retire in 2015 to match Justice Louis Brandeis' tenure. With a closely divided or narrowly Republican controlled Senate, a slightly left of center candidate would have to be tapped for the post.

In the scenario where Democrats control the White House for the next eight years, a conservative could retire or die. While retirement is unlikely, the latter is possible. Kennedy and Scalia are both 76 and have a life expectancy of 11.9 years. Yet the "death probability" tables indicate about a 50.5 percent chance, so it is likely, statistically speaking, that one would not survive until 2021.

While if Obama wins, the status

quo probably remains in the Supreme Court, the circuit courts and district courts will swing to the left — likely considerably. Likewise, if Romney wins, expect massive filibusters by the Democrats; but, in the end, a remaking of the judiciary for a generation. This will affect abortion rights, criminal procedural issues and tort claims to name just a few. The court house door won't be slammed shut, but it will be very hard for the disenfranchised, downtrodden or the poor to open. The unfunded and natural person (as opposed to a corporate person) will inevitably see less justice in the future.

With the combination of Kennedy and Scalia retirements with a Ginsburg departure that would allow Romney to appoint three new justices.

Many friends and colleagues tell me that Romney will be better for the economy. Obviously that is an important issue with significant debate about how best to manage a highly complicated U.S. economy. On the legal front, however, the choice is clear. The future of the "little guy," the minority, the 47 percent being able to vindicate his or her rights in court depends on Obama's re-election.

Eric B. Kingsley is a partner at Kingsley & Kingsley. His practice focuses on wage and hour and consumer class actions, and he has litigated cases in state and federal court, the California Court of Appeals, and the 9th U.S. Circuit Court of Appeals.