The New Normal

9 ways firms find cash for partners—at their great peril

Posted Jan 15, 2014 9:45 AM CST

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Each one of you who reads this is probably in some way a teacher and a mentor in addition to being a top-quality professional. You have learned and practice an important lesson at problem-solving from your experience, which Bill Lazier, the famous business professor from Stanford University, expressed thusly:

"Don't try to come up with the right answers; focus on coming up with good questions."

Having stretched his students with tough questions, the good and perplexing questions, when the students did come up with right answers—or with the right path to the right answers—out came the chalk and up on the blackboard went the answer.

One of the great questions, one of direct applicability to all industries that are impacted in a down cycle of the economy, is "What causes an organization to die?" With the infinite variety of businesses and industries, the initial response can be one of being overwhelmed. How can there be a simple answer that is also accurate? But there is one, and it applies to companies of all sizes and types. (Yes, that includes law firms.) And it comes from Professor Lazier as well:

"Organizations do not die from a lack of earnings. They die from a lack of cash."

So let us look at that one word: cash.

The beginning of the new fiscal year frequently calls the question of cash adequacy for the legal industry. That is when the full-year performance for the prior year is determined, the distributions of cash to partners is made for the prior year, and the prospects for the new current year are weighed heavily by the individual partners—the fundamental "buy or sell' decision on continuing their partnership, with "hold" or "stay put" being the renewal of the "buy" decision.

Has the start of every fiscal year always been so critical to the legal industry? No. "Buy or sell" used to be a decision made only once or twice in a law partner's career. The first time would be in response to the invitation to partnership; and thereafter when a seminal event, such as undertaking a major new lease, was required. Less often there might be a decision to make a redirection or change in career, such as in-house, the bench, joining a competitor or going into business. But in recent years, the lateral movement dynamic has been embraced by much of the industry, increasing the frequency of opportunity for partners to ask the question. And for a significant number of firms, the overwhelming consideration for many partners has become money.

This brings pressure upon firms to distribute cash. And thus, the seasonal challenge to the firm of the question every firm leader, firm partner, firm creditor, lender and landlord should be asking:

"Where will the cash come from?"

(If you answered: "I don't care, as long as I get it," apart from not being a great partner, you are probably headed for an unhappy experience in the near future.)

The answer isn't difficult: Surplus deposits of cash on hand after paying all current obligations and setting aside appropriate reserves for future short term requirements and working capital needs of the business.

It is when that answer is unsatisfactory—when the answer results in an unacceptable distribution level to partners—that the problems begin. The firm leadership can focus on fixing the problem with the support of the partners, or it can weaken the business by over-distribution. Over-distribution is facilitated by sourcing cash from outside of the answer above.

Unfortunately, over-distribution is mechanically easy to achieve and potentially difficult to reverse.

There are lots of ways to do this, and here are but a few.

1. Borrow it from a bank. This is an acceleration of yet-to-be-collected receivables into distributions today. The loan will have to be paid back, and as that will be even farther into the future, some significant portion of that responsibility will fall on people other than those who receive the distributions today. Thus, while it initially may sound acceptable, the ultimate outcome really translates to: "Take some or all of it from other partners in the firm."

2. Borrow it from existing partners. This is a funding through capital contributions from the partners. The difference from a bank loan is that it is usually interest-free during the time the partners are partners. Capital account balances contributed are often far in excess of any working capital need of the firm, and yet the money isn't there in bank accounts.

Where did it go? Some may go to expansion and growth of the business, either geographically or organically through headcount, which if done well will generate increased accounts-receivable balances. But some can disappear through distributions facilitated through overstatement of income as described below. This can be exacerbated by using "aspirational budgets" that over-optimistically forecast earnings for the prospective year, but require capital infusions from all or most partners at the beginning of the year. Year-end capital assessments can be used to offset increased "profits," so less actual cash needs to be distributed. Very handy if the firm doesn't have cash to distribute anyway.

3. Borrow it from withdrawn partners. This is an interest-free term loan by returning withdrawn partner capital without interest over a term of years and not immediately (and as contrasted with taking in new partner capital in full immediately on admission to the partnership).

4. Borrow it from new partners. Aggressive lateral hiring, even at premium rates and with guarantees, infuses much-needed tax-free cash capital.

5. Borrow it from the qualified pension plan. This is funding the partner pension plan not in the current fiscal year, but with monies received in the following fiscal year, and often with receipts from work performed in the following fiscal year.

6. Borrow it from the retired partners. Defer or delay payouts to retired partners pursuant to unfunded retirement plans.

7. Borrow it from vendors. Defer payment of expenses until the following fiscal year.

8. Borrow it from landlords. Defer payment of rent for one or more periods until the following fiscal year.

9. Change accounting characterizations. Convert expense items into "assets" that are then amortized over a term of years. This technique (as well as Nos. 7 and 8 above) serves to increase reported current income, thus enabling the distributions to be made from "profits" that weren't really there.

There will be those who would argue that surely some of this is not bad or shouldn't be fatal to a business, and a bit of "fine tuning" of results should be acceptable. So be realistic and answer a different question: "How much of this can we do and still be safe?"

The answer can be any of many questions that balance what one may want that involves self-destructive behaviors with what is safe. "How many bullets can you load into the revolver for a game of Russian roulette and still be safe?" "How many human growth hormone shots can I inject before it isn't safe?" "How many LSD tabs can I swallow before it isn't safe?"

There are plenty of signs other than cash that narrow in on an organization that is headed towards failure, but the fundamental of cash and its sources and uses is a powerful touchstone to always include in the evaluation.

The good news comes through two final questions. The first is: "How long has this been the case for law firms?" The answer is: "It was ever thus." This is nothing new—unless you are a leader and have not grasped the connections to date.

The second is: "How do we make ourselves strong and safe so our organization does not die?" The answer includes much that is specific to each unique firm, but for all firms the answer should include: "Don't pick from the nine choices above."

The path is completely within our control to both set and to change. If we aren't doing the above, keep it up. If we are doing the above, we just have to change before we run out of cash. If we are doing the above and we do not change, then it was by the choice of those who decide.

Those choices above are the outcomes of very discrete decisions, not because the economy was bad, and the outcome will then become more a question of "when" than "whether."