Getting 'real' about law firm balance sheets

By Ed Reeser

Using capital wisely can be more important than having lots of capital.

As we observed in the first installment of this two-part series, a "tightening of the belt" on distributions at the equity partner rank won't necessarily by itself solve the problem of cash flow squeeze, so what can a firm do? We are seeing firms institute programs of withholding of income as "bonus pool" money for income partners, and perhaps some classes of associates, that are not paid until after the end of the year and dependent on meeting certain metrics of performance, either at the individual level, the office level, practice group level, firmwide level or some combination of those. That relieves current period cash flow demand somewhat. It can also shift some downside risk of underperformance to non-equity classes, while not proportionately sharing upside rewards of beating the budget! But there is a liability, and it probably isn't being considered in the "we have no debt" mantra. Not all of the hold back or bonus is typically "at risk" to the employee, and therefore, it really is interest free "borrowing" from people. And possibly shifting of some of that expense to the next accounting year. Another approach some firms have taken is to implement a non-transparent compensation model, so that some partners are deferred on distributions, and others are not, without disclosure of this program. Note that while these are actions taken, they are not solutions to the problem that is creating them. They are just means of extending the overdistributions to partners.

Another aspect of a heavy partner capital program is that while the firm receives a large infusion with each new partner admitted to the partnership, it has to distribute a large amount with each partner departing. If the firm goes through a significant series of partner departures in a short period of time, the equity will shrink, perhaps rapidly, as the cash from the left side of the ledger pours out.

Since the number of equity partners in some firms is relatively few, heavy per partner capitalization does not necessarily mean the firm has more stability. It is the total equity invested in the enterprise relative to the need for short term working capital that matters, not how much more a smaller class puts in to their firm compared to "peer" firms. Departures of partners from that class can have a more dramatic impact on the balance sheet ratios than in a firm with more partners. What may sound stronger at first hearing, is in that instance actually a weaker firm.

If the firm does not pay out all of the capital returns to departing partners on a current basis, and instead trickles it out over a term of several years, the cash outflow is slowed for a time, but now there has to be an entry on the balance sheet for amounts owing to departed partners. The firm is borrowing money, just not from banks. That installment capital return program will impact future periods as cash received as taxable income to partners will have to be applied to non-deductible capital returns to departing partners. Is the firm doing this? Many do. And yes, it is "debt."

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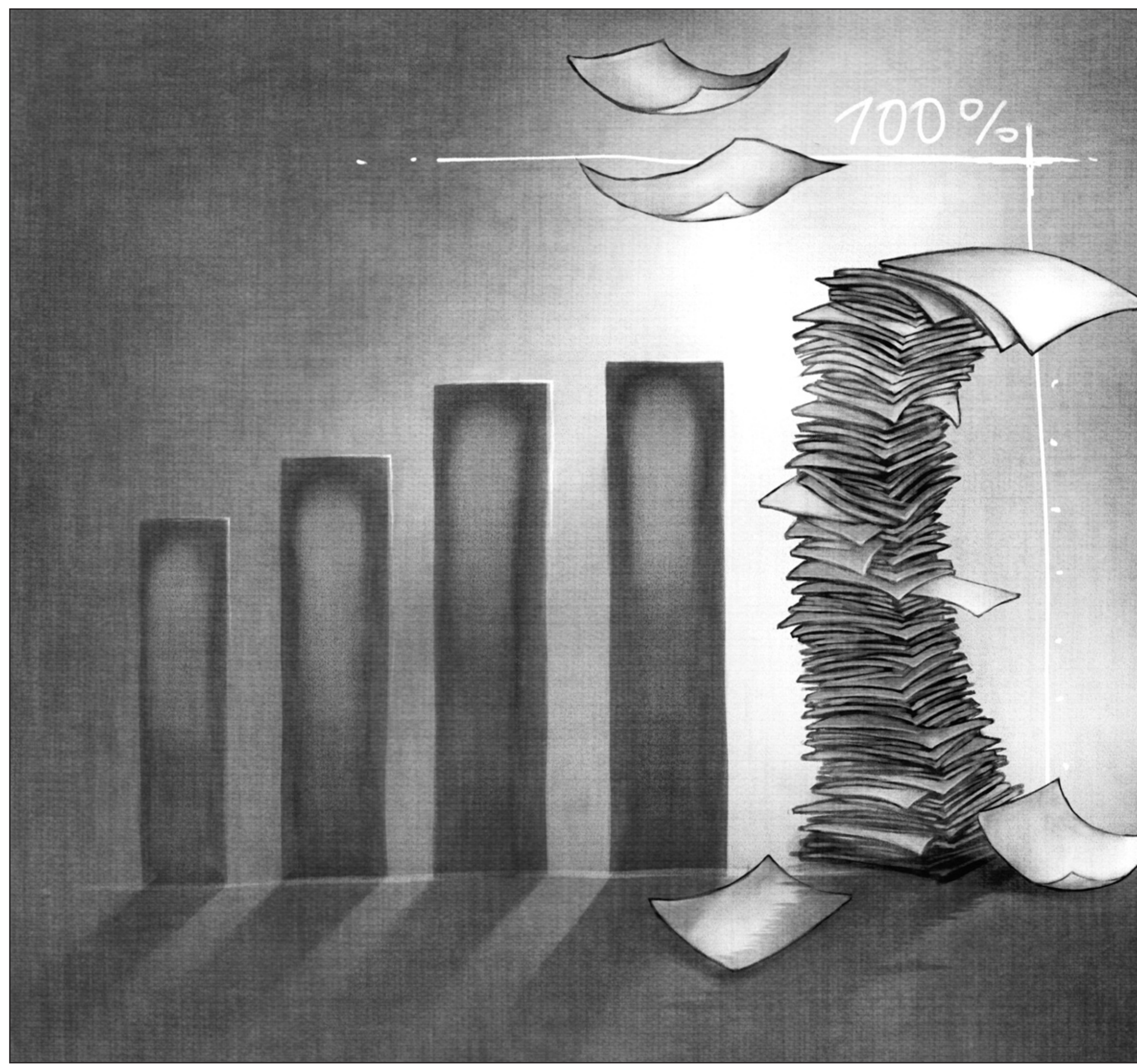

If the firm requires a capital infusion from other classes, not just "equity partners," then the installment payout provision becomes potentially even greater as a lever against the equity class if significant reductions in headcount begin across lower ranks. Once again, we see that how a firm handles these capital items can create liabilities, often primarily for the purpose of preserving cash that is then applied to the partner distributions.

Another aspect we have discussed in the past is the capitalization for accounting purposes of certain items of expense using modified cash basis accounting. If the firm capitalizes recruiter fees, and "pipeline period" start up expenses of lateral hires, that accounting treatment can build up a significant continuing obligation for future years. It is deductible, but it requires a significant future cash payout. It appears as an "asset," replacing cash that is used currently to pay those fees and costs, but supports a higher equity entry than otherwise would be there. Take that, and any other "massaged" entries on the asset side, write them off on both the asset and equity side, and then take a look at the balance sheet totals! Note how the technique overstates current income, to the detriment of future periods, potentially enabling increased current cash distributions. The 'debt' is the amortization burden that is born every year that wasting asset is in existence, and it is not an 'asset' that is delivering a classic return, but is a mask for hiding current recognition of large cash outflows.

A close examination of the firm's operating margin is in order. A strong margin (35-40 percent plus) is very important to achieve. You can have more partners, more cushion against downturns. If the margin is narrow, then if the firm is returning partner capital over a term of years, or capitalizing recruitment and pipeline costs, there is an even weaker capital position than at first understood.

If the operating margin is narrow, but the firm returns all withdrawing capital immediately, and if there is current expensing of all recruitment and start up costs for new hires, then the financial position is stronger, possibly stronger than firms reporting wider profit margins, but applying the capitalization of expenses method to overstate current income to the detriment of future reporting periods.

The mantra of having no debt is not without some significance, but it is only one metric, and probably not as important as having a strong operating margin. Large profit margins in a stabilized business model give more security than low profit margins. A swing in business fortunes can hurt a wide margin business, but sink a low margin one. Debt on top of low margins can just bring the ending sooner.

The elimination of the debt component can make an easier to see, clearer to understand dynamic. Specifically it is easy to determine whether and how there may be a transfer of wealth internally in a law firm. Typical indicators are evidenced through some of the above described mechanisms of continuing overdistribution policies, potentially in support of wide compensation spreads in partner compensation. If the compensation system is not transparent, this could be an important dynamic that many partners are not aware of, notwithstanding the fact that the firm "has no debt."

Both the debt and "no debt" business models can wind up on the same trash heap of failure. If the enterprise does not generate sufficient distributable cash on a sustained basis to carry the enterprise, then all that a heavy capital program has done is underwrite the inefficiencies for a longer period of time until the quotient of rate of return on assets invested that is tolerable has been reached or exceeded. Note that at such a tipping point, the partners who have been the beneficiaries of the overdistribution policy have strong incentives to leave the firm and start over, not just those that have underwritten it and were theretofore unaware! Strong operating margins generated by sustainable income flows and cash balances are what make winners, not per se whether they use debt or equity to deliver it. Since law firms are not operations that require huge amounts of capital to operate, there are limited needs for debt or equity. A stable and quality receivables base and some cash reserves, with consistent and reasonably level receipts from month to month, or quarter to quarter, delivering distributable cash is what is required. Accounting tricks, governance tricks with respect to return of capital, management policies that take or defer income from other classes, or stealthily reallocate it internally within the equity ranks, are draughts of financial absinthe.

There can be "borrowing" in the "no debt" model — the partners just lend it to themselves.

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Sellers of goods find protection in the Bankruptcy Code

By Claire E. Shin

Sellers and service providers regularly extend business credit to their customers. However, if a buyer or customer files for bankruptcy and becomes a debtor in a Chapter 11 bankruptcy case, unpaid trade creditors must refrain from collection efforts against the buyer/customer, unless specifically authorized to do so by the bankruptcy court or bankruptcy law. Frequently, trade creditors end up with a general unsecured claim in their customer's bankruptcy case, with the right to file a proof of claim with the bankruptcy court, but often without prospects for full recovery.

Title 11 of the United States Code, commonly known as the "Bankruptcy Code," grants vendors the right to reclaim products that are delivered to a Chapter 11 debtor within a specified timeframe. Reclamation can be an important tool to assist vendors in getting their pre-petition claims paid.

Section 546(c) Reclamation

A trade creditor can reclaim goods sold on credit that an insolvent debtor received during the 45-day period prior to the filing of bankruptcy, so long as the creditor sends the debtor a written notice demanding reclamation of goods (1) within 45 days after the goods are received or (2) within 20 days after the bankruptcy filing if the 45-day period expires after the bankruptcy filing date. The automatic bankruptcy stay does not prevent a creditor from sending a demand letter to the debtor to enforcing its reclamation claim. However, one issue that may often arise is whether or not the "blanket lien" of the lender to the business attaches to the goods once they are received by the debtor.

Immediately after learning of the buyer's bankruptcy filing, a creditor should verify whether the bankruptcy court has entered an order establishing procedures dealing with reclamation claims. Otherwise, the creditor should consider, promptly and hopefully before the buyer-debtor disposes of the goods, filing a reclamation lawsuit in the bankruptcy court. The lawsuit can include a request for temporary restraining order that prohibits the debtor from disposing of or altering the goods. The creditor may wish to communicate with other reclamation creditors to coordinate their reclamation efforts.

By acting quickly, the creditor might compel the debtor to immediately address the creditor's claim and avoid the argument that the creditor idly sat on its claim. Failure to take swift action could lead to a loss of rights. In the *Circuit City* bankruptcy case, a creditor had timely sent a reclamation demand for the return of over $11 million in goods received by the debtor within 45 days prior to the bankruptcy filing. Thereafter, the creditor did not take further action to enforce its claim. Approximately seven months later, the debtor objected to the reclamation claim, and the bankruptcy court ruled in favor of the debtor, based on the creditor's failure to diligently pursue its reclamation claim. It should be noted that special rules may apply to agricultural products and other perishable food.

The seller's failure to timely demand reclamation, however, generally does not eliminate the seller's claim entirely. The seller can still assert its rights to an administrative expense priority claim under Section 503(b)(9) of the Bankruptcy Code. However, Section 503(b)(9) claims are limited to the value of goods received by the debtor within 20 days before commencement of the case, and not the goods themselves.

Section 503(b)(9) "20-Day" Administrative Expense Priority

Section 503(b)(9) of the Bankruptcy Code grants sellers of goods an administrative expense priority claim for the value of the goods they had sold to a debtor in the ordinary course of business of the debtor's business and that the debtor had received within 20 days before its bankruptcy filing. An administrative expense claim often provides unpaid trade creditors with valuable leverage in bankruptcy cases. A qualifying claim for goods that the debtor had received on credit terms shortly before the bankruptcy is granted a "step-up" in priority to a higher ranking. This step-up in priority is important because, as a general rule, an administrative expense claim stands behind only secured claims, and must be paid in full when the debtor's plan of reorganization or plan of liquidation becomes effective, before any general unsecured creditors or equity interest holders can be paid.

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Section 503(b)(9) provides that creditors are entitled to an administrative expense priority claim for "the value of any goods received by the debtor within 20 days before the date of commencement of a [bankruptcy] case in which the goods have been sold to the debtor in the ordinary course of such debtor's business."

However, allowance of a Section 503(b)(9) claim is not automatic or self-executing. Rather, such claims will only be allowed after "notice and a hearing." This generally means that a creditor must file a motion for allowance of the claim and provide the debtor and other parties-in-interest the opportunity to object to the claim. Creditors should also be cognizant of the deadline for asserting Section 503(b)(9) claims. As a general rule, this deadline is set by court order. Creditors should be alert for notice of the deadline to file a claim. Failure to do so may result in the complete loss of the claim.

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