BUDGETING FOR A BANNER YEAR

Ellen Freedman, CLM

Law firms have natural tensions and pain points that are the enemies of growth and prosperity. Most firms that do substantial amounts of contingent work ride a financial roller coaster throughout the year. It is not uncommon to dig deep into the firm's line of credit to get by. Then a big fee comes in. With a huge sigh of relief past due bills are paid, the line is dramatically reduced and bonuses are dispensed. Not long thereafter, the cycle begins anew.

Lawyers who work on an hourly or flat-fee basis shudder at the thought of riding the contingent financial roller coaster. They gladly forgo the "big hit" to more easily predict cash flow and earnings. From their perspective law firm life is stressful enough without that additional angst.

Firms that are home to both hourly and contingent practices often maintain an uneasy balance between the two. Conflict seems to bubble under the surface, erupting occasionally into heated exchanges or worse—a heated departure. Those with hourly practices are quick to point out that without their steady contribution the monthly nut, including payroll, would not be covered. Contingent practice attorneys frequently point to the lower effective hourly rate of their counterparts. They point out that hourly work is like running on a treadmill; one can only run for so long before collapsing. They know that the big payoffs come from their efforts. They can make or break the financial goals of the firm based on a single case.

Contingent attorneys in mixed practice firms are acutely aware that everyone in the firm has his or her hand out for a bonus whenever a big fee comes in. Yet contingent attorneys are frequently criticized in between for the cost of financing cases—and for every case that doesn't result in a win. And, too often, they are resented for being "carried" by the steady revenue of those working hourly or for flat fees.

During a typical year I work with upward of 3,000 law firms and lawyers.

A majority of those I assist practice in solo and small-firm environments. It comes as no surprise that I find little financial planning in firms of this size. What surprises me is how little financial planning, or at least effective planning, I find in firms with five to approximately 20 attorneys. Sometimes even larger firms fail to plan effectively, particularly with respect to treatment of profits in a good year.

During the recent economic downturn, an untold number of articles were written about how to survive in the troubled economy. Articles offered helpful suggestions and tactics for survival, but I do not recall a single one addressing the best practices for a year that *exceeded* expectations. Oddly, the few success stories went unreported amid those highlighting firm explosions, massive layoffs and quietly desperate dissolutions.

Now that the legal economy has sluggishly started to pull itself back up, it's appropriate to address this issue.

THE PROBLEMS OF COMPLETE DISTRIBUTION

Lawyers, almost without exception, have a mindset that it's better to distribute every penny of profit to owners, even when it leaves the firm cash poor, rather than pay a dime in tax on profits. During lean times, it was feared that failure to distribute every available penny would result in defections.

The problem with the complete distribution mindset is that it consistently produces the same results. First, it leaves most firms struggling to pay bills during the first few months of the year because typically all the cash has been distributed at year-end. Many firms routinely dip into their lines of credit just to cover payroll during the first few months of the new fiscal year.

Second, it leaves the firm undercapitalized. Money to upgrade the firm's technology infrastructure, finance lateral hires or a new office is not available. The thought of owners scaling back draws to finance such things is quickly squashed. Whereas large firms have capital reserves, and occasionally capital calls, which enable them to continue to act strategically, the midsize and small firms leave themselves without capital reserve for infrastructure improvements and implementation of strategic moves. So while, theoretically, small or midsize firms can move more nimbly in taking strategic action, their lack of financial planning often leaves them incapable of doing so.

BEST PRACTICES

What should a firm do? What best practices should you consider implementing when times are good? There are a variety of suggestions to offer. But before you can decide which will work best for your firm, you need to step back and truthfully assess the cultural mindset.

If your firm is one where there is a mixed practice of contingent and hourly and/or flat fees, emotional issues likely will come into play. You need to develop clear rules defining what fees will be considered "windfall" and how they will be treated for compensation purposes. (Note that I have purposely avoided using the word "excessive" because that has negative and ethical connotations.) The time to start discussion is not when the big fee is deposited. That is a formula for a flash fire of flared tempers and the development of deep wounds that may never heal.

At one well-managed midsize firm, the partners have developed what I consider a smart methodology that keeps everyone happy. Upon receipt of a windfall fee, they immediately distribute bonuses to those who participated in the matter, on the first 50 percent or more of overage beyond time investment (depending on the size of the fee). The balance is immediately moved to another account that is reserved for year-end strategic action.

At year-end the executive committee looks at the available money in this account. Its members take into consideration (1) the profit-sharing distributions to all stakeholders; (2) special distributions to reward outstanding efforts by a particular stakeholder; (3) special circumstances that may require rectification, for example, a particularly bad year for someone for reasons beyond his or her control, such as illness; and (4) any special capital needs for the coming year. In other words they reward those who produced the big win and then they look at the big picture from a strategic perspective before distributing the remaining balance.

Here are some practices your firm should consider in a banner year:

Make a capital investment. Most law firms are severely undercapitalized. Bringing a firm to a zero profit at year-end requires that cash be withdrawn directly in proportion to profit. It's unrealistic to expect a firm can do this year after year. Take a look at the firm's strategic wish list and set aside some of the cash to invest smartly in an item or two on that list. Do this *before* determining and making profit distributions. Consider a smaller "tax bonus" to stakeholders instead of a profit bonus. If your entity structure causes every penny of paper profit to flow to stakeholders personally, thereby creating a tax consequence, make a distribution payable to their prepaid tax rather than to the stakeholder. It will take some of the sting out of making the capital investment.

Prepay some of the significant business expenses that come due in the first few months of the next fiscal year. This will both reduce profit in the current year and greatly ease cash flow in the following year's first few months. If your firm suffers from an inability to make distributions (i.e., "draws") to stakeholders in the first few months due to lack of cash, this will alleviate some of the problem.

Pay down the line of credit. If your outstanding balance is significant and hasn't budged for years, or has continued to increase, it will take considerable diligence and fortitude to pay it down. Don't risk running into a real financial emergency when your line is almost maxed out. Banks nowadays don't just hand out money to firms in need. They only do that when they are pretty sure you do not really need it. So make a plan to reduce your outstanding balance significantly each year the firm is profitable—and stick to it.

Consider negotiating a lump-sum buyout for a reduced amount. If your firm has obligations to retired partners that stretch out for years to come, a good year can afford you the opportunity to get out from under the obligation. For firms concerned about holding onto their next generation of stakeholders, discharging these obligations can have very positive results. Very often a retired partner will willingly take less to get all his or her money at once.

Vote out your 900-pound gorilla. OK, this one probably catches many people by surprise. I get that. But in my dealings with firms, I too frequently encounter very nice but hapless stakeholders who spend their days fighting a terrorist in their midst. They put up with it day in and day out because they are afraid that the economic consequence of standing up will destroy the firm and their livelihoods.

I am here to tell you that your best chance of survival, and the optimal time to take action, is when you've had a very good year. Instead of responding with complacence that at least the money was good this year, consider tightening your belt and investing the profit in your future sanity. Those who have found the intestinal fortitude to do so found that life can go on without dreading coming to the office each day. They just keep asking themselves, "Why did we put up with it so long?" It takes a lot of guts. But your best chance is when you've had a good year. Just think about it.

CONCLUSION

Depending on the culture of your firm, how much tension might exist between practice areas—and even how fiscally responsible individual members of the firm might be in their personal lives—the pressures that come to bear to make large profit distributions in a good year may range from mild expectation to angry demand. For that reason it's important to plan in advance what the firm will do when a banner year arrives. Yes, there must be reward for people who have exceeded goals and contributed to the success. But those rewards should never be granted without thinking about the well-being of the firm, as an entity in and of itself, which also needs nurturing.

Ellen Freedman is the law practice management coordinator of the Pennsylvania Bar Association. She assists bar members with issues and problems that arise on the business side of their practices. She is also president of Freedman Consulting, a full-service law practice management consulting firm she founded in 1998.
ellen@freedmanlpm.com