Capitalisation: what it should mean to you

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Your legal firm has just completed a successful year.

Your personal year was terrific...1500 billable hours for a total of $400,000; and you originated $100,000 in new client billings for the firm.

The prospects for next year are even better for both you and the firm.

However your draw plus bonus was less than expected as the executive committee decided to withhold a portion of the earnings to provide the capital needed for next year.

Your reaction and the reaction of many partners in similar situations is that you have somehow been penalised.

You realise that the conservation of cash is important in these times and that it will mean more money for you someday in the future.

But that event is speculative and of little value to you today.

You even understand that frowth creates the need for more capital.

But somehow you believe that the money withheld is going to disappear into a muysterious chasm invented to serve the machinations of the executive committee.

Accordingly, it is critical that partners understand the importantce of capital and exactly what it is.

What is Capital?

Capital is the money or investment required to support the assets and activities of the firm.

Your law firm is a business and, like any other business, requires an investment of capital to generate a stream of future earnings from which you will derive your compensation.

A law firm basically requires two types of capital:

* Permanent or fixed capital. This is the money invested in the fitout, the furniture and equipment. It is analagous to the investment a manufacturer makes in plant and equipment;
* Soft of working capital. This is the money tied up in the operations of the firm. Put another way, a legal firm has to fund the operations until the fees and disbursements are rendered and collected. This is the working capital of the firm.

How Much Capital is Required?

When your firm set up office or moved to its present location, a decision was made as to the quality and type of furniture, equipment, fitouts and so on. This determined the level of permanent capital required.

The plushier your offices or the greater the degree of sophistication of your technology, the greater the investment.

These are essentially one-time decisions which have an impact over a number of years.

although it is difficult for a fee earner individually to effect the level of permanent capital, all fee earners can effect the level of earning capital required.

Remember that working capital was defined as the capital necessary to fund operations until the fees and disbursements have been collected.

Essentially, the firm is funding its work in progress and debtors or, more correctly, the costs incurred to generate these assets (ie salaries and overheads).

For instance, if your total lock up is $1,000,000 and your firm is making 40 per cent on every dollar billed, you are required to fund 60 per cent of this amount, or $600,000.

Two important factors can be extrapolated from this:

* The more profitable the firm, the smaller the capital investment required and the more that will be available for partners' compensation;
* The longer your work in progress and debtors are outstanding, the longer your capital investment is tied up.

In periods of growth, whether by mergers or internally, additional working capital is required.

One must be aware that the hiring of solicitors is an investment in future profits which requires immediate funding.

Furthermore, capital will be required to finance liabilities not yet recorded or recognised by the firm.

Examples of this include unfunded retirement plans and buyouts of partners due to death, disability or withdrawal.

How is Capital Financed?

Capital for legal firms can be provided in the following ways:

* Undistributed earnings;
* Capital contributions;
* Bank borrowings;
* Partner loans.

The mix of the alternatives a firm chooses depends upon the collective risk profile of the partners.

Some firms are comfortable with high levels of bank debt and the corresponding increase in financial risk.

Others choose to have minimal debt.

There is no standard approach.

Generally I would recommend that permanent capital be funded by long term sources (long term bank debt and capital contributions) and working capital be funded by a mixture of short term bank borrowings and undistributed earnings.

In addition, I would recommend that firms reduce their financial risk in tough economic climates by following a more conservative capitalisation policy.

Finally, there are still some firms that pride themselves in not requiring capital contribution from new partners.

This is an exercise in self delusion and does nothing for the "employee mentality" that exists among so many partners.

Conclusion

The complex financing needs of today's legal firm requires a higher level of capitalisation than in the past and a clearer understanding by all partners on the nature and the need of capital.

It should be realised that the capital structure chosen is the result of negotiations among the partners and represents compromises between the different situations that each individual brings to the table.