

## LAW FIRM DEBT: HOW MUCH IS TOO MUCH?

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The dissolution of law firms is not new — nor is the issue of excessive debt — and the frequency of both may accelerate as the economic slump drags on.

We have been vividly reminded of the relationship between the two with the demise of Silicon Valley powerhouse Brobeck, Phleger & Harrison, LLP. Such an event may bring home a nagging question about your firm's finances. If you are looking for a quick guide to whether your firm has taken on too much debt, here are some easy metrics that you can use as an early warning system.

These metrics are intended as a quick check and should not be taken as a determinative judgment of the firm's fiscal condition. Failure to meet any of these standards should prompt further examination before judgment is rendered. Law firms may not meet one or more of these metrics and still be okay. All metrics are as of the end of your fiscal year.

### Metrics:

- 1) Add together the collectable value of your unbilled time and accounts receivable. The combination should be five times your total debt (bank and capitalized lease obligations).
- 2) The total amount of debt should be no more than 100% of the net book value of your fixed assets; 90% is okay, but 80% or less is much better.
- 3) Your line of credit balance should be zero at year-end and for most of the year. The credit line should not be used to pay partners or as your first source of working capital. It should be there to augment working capital, covering unusual economic conditions (i.e. negative economic performance beyond one standard deviation of norm).
- 4) The capital or owners' equity section of your cash basis balance sheet should be positive after all current year income has been distributed. This is your permanent capital.
- 5) You should not be in breach of any of your loan covenants. There are many covenants that you and your bank agreed to when the loan was secured (they vary from bank to bank and loan to loan). It is important to ensure that those covenants can be met. Failure to do so can result in higher interest rates being charged, possibly additional fees assessed, and even the loan being called. Technically the bank can declare you to be in default and exercise any rights they have under the default provisions of the loan agreement. If you are in default, get out in front of the issue — prepare a presentation to disclose the problem, put it into as favorable and honest a context as possible, show what corrective action is being taken, ask for a waiver during the corrective period.

*Continued...*

**A 150-lawyer firm with debt problems:**

## Assets

Cash	\$ 4,800,000
Net Fixed Assets	3,000,000
Other Assets	<u>3,300,000</u>
Total Assets	<u>\$11,100,000</u>

## Liabilities

Term Debt / Capitalized leases	\$ 3,500,000
Line of Credit	5,000,000
Other Liabilities	<u>1,300,000</u>
Total Liabilities	<u>9,800,000</u>

## Capital/Equity

Permanent Capital	800,000
Undistributed Income	<u>500,000</u>
Total Capital	<u>1,300,000</u>

Total Liabilities and Capital \$11,100,000

## Off Balance Sheet Assets

Unbilled Time	\$ 7,000,000
Accounts Receivable	<u>6,300,000</u>
Total	<u>\$13,300,000</u>

## Metrics:

- 1) Unbilled time plus accounts receivable : Debt  
 $\$13,300,000 : \$8,500,000 = 1.56$ , which is less than 5
- 2) Debt / Net Fixed Assets  
 $\$8,500,000 / \$3,000,000 = 283\%$ , quite obviously higher than 90%  
If you paid off the line of credit the term debt is still too high ( $\$3,500,000 / \$3,000,000 = 117\%$ )
- 3) Line of Credit Balance  
Year-end balance is \$5,000,000. It should be zero.
- 4) Permanent Capital  
Year-end balance is \$800,000, which is still positive. However, there is insufficient cash to pay the line of credit, let alone the other liabilities and year-end profits.

**An average 150-lawyer firm:**

## Assets

Current Assets	\$ 7,800,000
Net Fixed Assets	6,300,000
Other Assets	<u>900,000</u>
Total Assets	<u>\$15,000,000</u>

## Liabilities

Term Debt / Capitalized leases	\$ 3,500,000
Line of Credit	0
Other Liabilities	<u>1,300,000</u>
Total Liabilities	<u>4,800,000</u>

## Capital/Equity

Permanent Capital	2,700,000
Undistributed Income	<u>7,500,000</u>
Total Capital	<u>10,200,000</u>

Total Liabilities and Capital \$15,000,000

## Off Balance Sheet Assets

Unbilled Time	\$ 9,800,000
Accounts Receivable	<u>10,700,000</u>
Total	<u>\$20,500,000</u>

## Metrics:

- 1) Unbilled time plus accounts receivable : Debt  
 $\$20,500,000 : \$3,500,000 = 5.9$ , which is greater than 5 times
- 2) Debt / Net Fixed Assets  
 $\$3,500,000 / \$6,300,000 = 56\%$ , which is lower than 90%
- 3) Line of Credit Balance  
 Year-end balance is \$0. It should be and is zero.
- 4) Permanent Capital  
 Year-end balance is \$2,700,000, which is positive and there appears to be sufficient current assets (predominately cash in most law firms) to pay out the undistributed income, although there does not appear to be sufficient cash to fund distributions plus pay the other liabilities and have cash on hand to provide the initial working capital in the new year without reliance on the line of credit.

**A 60-lawyer firm with debt problems:**

## Assets

Cash	\$1,900,000
Net Fixed Assets	1,200,000
Other Assets	<u>1,300,000</u>
Total Assets	<u>\$4,400,000</u>

## Liabilities

Term Debt / Capitalized leases	\$1,400,000
Line of Credit	2,000,000
Other Liabilities	<u>500,000</u>
Total Liabilities	<u>3,900,000</u>

## Capital/Equity

Permanent Capital	300,000
Undistributed Income	<u>200,000</u>
Total Capital	<u>500,000</u>

Total Liabilities and Capital \$4,400,000

## Off Balance Sheet Assets

Unbilled Time	\$2,800,000
Accounts Receivable	<u>2,500,000</u>
Total	<u>\$5,300,000</u>

## Metrics:

- 5) Unbilled time plus accounts receivable : Debt  
\$5,300,000 : \$3,400,000 = 1.56, which is less than 5
- 6) Debt / Net Fixed Assets  
\$3,400,000 / \$1,200,000 = 283%, quite obviously higher than 90%  
If you paid off the line of credit the term debt is still too high (\$1,400,000 / \$1,200,000 = 117%)
- 7) Line of Credit Balance  
Year-end balance is \$2,000,000. It should be zero.
- 8) Permanent Capital  
Year-end balance is \$300,000, which is still positive.

**An average 60-lawyer firm:**

## Assets

Current Assets	\$2,100,000
Net Fixed Assets	1,500,000
Other Assets	<u>400,000</u>
Total Assets	<u>\$4,000,000</u>

## Liabilities

Term Debt / Capitalized leases	\$1,000,000
Line of Credit	0
Other Liabilities	<u>700,000</u>
Total Liabilities	<u>1,700,000</u>

## Capital/Equity

Permanent Capital	1,000,000
Undistributed Income	<u>1,300,000</u>
Total Capital	<u>2,300,000</u>

Total Liabilities and Capital \$4,000,000

## Off Balance Sheet Assets

Unbilled Time	\$3,800,000
Accounts Receivable	<u>3,600,000</u>
Total	<u>\$7,400,000</u>

## Metrics:

- 5) Unbilled time plus accounts receivable : Debt  
 $\$7,400,000 : \$1,000,000 = 7.4$ , which is greater than 5 times
- 6) Debt / Net Fixed Assets  
 $\$1,000,000 / \$1,500,000 = 67\%$ , which is lower than 90%
- 7) Line of Credit Balance  
Year-end balance is \$0. It should be and is zero.
- 8) Permanent Capital  
Year-end balance is \$1,000,000, which is positive and there appears to be sufficient current assets (predominately cash in most law firms) to pay out the undistributed income.