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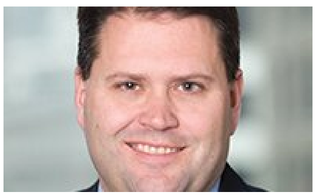
Envision the Future and Make It Happen

Capital planning and retention can be a contentious topic among law firm partners — often because the issue involves just how much will be coming out of each individual's pocket.



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Nevertheless, it is a process that is crucial to the short- and long-term well-being of your firm. To ease the planning along, it is useful to break the process down so that all involved will see clearly what is necessary and important for their future.

IDENTIFYING YOUR NEEDS DURING THE NEXT 1, 3, 5 YEARS

Your firm's capitalization needs turn on a number of variables that you will need to consider as part of the long-term strategic business plan. These include:

- Firm strategy and growth initiatives such as laterals and potential mergers
- Projected operating cash flow
- Real estate, additional office space and equipment needs — particularly technology costs
- Unfunded pension obligations
- Maintaining competitive compensation for partners and essential staff
- Risk tolerance of your organization — loss of major client, rainmaker departs, practice area declines

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CONSIDERATIONS AND OPPORTUNITIES

Once you have sorted out the needs that are most important to the partnership, you must now weigh factors that will influence your decisions.

Phantom income. Weigh your needs against the phantom income that capital retention generates. Phantom income often occurs when income is passed to the partners whether the cash was actually distributed to them. The cash may have been retained for firm costs, but the onus of paying the taxes on that income falls to the individual partners.

Financing. Decide whether you will finance costs from working capital or through debt — capital/operating leases or bank lines. The current low-interest-rate environment provides an attractive option for firms to use debt to finance equipment, technology or real estate needs. In turn, the firm can spread the cash flow effect of such investments throughout a period of time to minimize the effect to the firm's capital structure and to partner's distributions.

PARTNERSHIP AGREEMENTS

Consider amending your agreements to include a ceiling on distributions to retired or departing partners not to exceed a percentage of revenue in a given year. Then, the firm can retain capital to manage the business effectively and potentially reduce your need to borrow.

STAYING FLEXIBLE

Any capital plan should remain fluid, be reassessed periodically and adjusted as firm policy changes and unanticipated challenges and opportunities present themselves. Consider a target capital account balance by partner. This can be a percentage of earnings, excluding bonuses. Industry benchmarks for this approach range from 35 to 40 percent.

ABOUT THE AUTHOR

John Fitzgerald, CPA, with Berdon for more than 20 years, is an Audit Partner and Chair of the firm's Law Firm Services Group. Consulting with practice leaders, he evaluates the financial and economic impact of partnership agreements and reviews candidates for mergers and lateral partner additions. To help firms secure long-term financial strength, he structures and arranges financing and refinancing.

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