

LEGAL MANAGEMENT

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Take Charge of Your Creditworthiness

Banks are in the business of loans, but they won't loan to just anybody. They want to make sure those they approve have good credit and minimal risk.



ED POLL, JD, MBA, CMC

Principal of LawBiz® Management

After all, banks want to ensure — as best they can — that they will eventually get their money back.

Once your bank understands your law firm's viability as a business entity, it will want assurance that you are creditworthy as a customer. Banks extend credit to law firms based on the results of two general types of testing measures: quantitative and qualitative.

QUANTITATIVE MEASURES

Quantitative measures include a FICO credit score and/or the credit-reporting agencies' VantageScore system. Regardless of the scoring system used, it is certain that consistently paying bills on time, having a long history of paying different types of bills and using credit modestly will result in a higher credit score.

- **FICO Credit Score:** This score, created by Fair Isaac Corporation (a credit analysis firm), is the number that most bankers use to determine whether they want to lend money to someone. Essentially, the number is an estimate of the risk that you will default on a payment, generally within the first three years of a loan. The national median score is 720, and the highest possible is 850. Your FICO score is based on your history of borrowing and repaying money. Therefore, knowing your score in advance of applying for a loan can make the process flow more smoothly.
- **VantageScore:** The three national credit-reporting agencies that serve as the repositories of individual and commercial credit reports are Equifax, Experian and TransUnion. All three companies have standardized how they calculate consumer credit scores in order to provide a more consistent credit-scoring process. This system is now called VantageScore. The system gives scores ranging from 501 to 990, which in turn translate to grades of A through F.

The first question a banker asks is whether the ethics, business practices and general reputation of the prospective customer or borrower are such that the bank can feel comfortable. In other words, does the bank want to do business with this party?

QUALITATIVE MEASURES

Ultimately, the qualitative factors that bankers use to gauge your creditworthiness are more important than quantitative score numbers are. Collectively called the Four Cs, these factors include character, collateral, capacity (also called cash flow) and capital. Bankers seriously weigh these factors in their decision-making processes.

- **Character:** The first question a banker asks is whether the ethics, business practices and general reputation of the prospective customer or borrower are such that the bank can feel comfortable. Some examples of character are honesty, integrity, ability and reputation in the community.
- **Capacity:** Next, the banker will check that the law firm's cash flow is sufficient to justify confidence that the loan and its carrying costs will be paid back on time. A cash-flow statement must be submitted for the bank's consideration. Calculating the ability to repay a loan is a process of identifying and deducting the practice's expenses from the monthly cash received.
- **Collateral:** Even if the bank is careful in agreeing to provide a loan, the loan could still go into default. So if all else fails, how will the bank's outstanding loan be repaid? That's where collateral can be a hard asset such as a house, another piece of real estate or equipment used in the operation of the law firm. Collateral can also be a personal guarantee by someone with adequate wealth to honor the guarantee if you default. It can include securities and a lien on accounts receivable as well.
- **Capital:** The bank needs to know what the loan funds will be used for. Then, if the loan proceeds will be used to purchase an asset, the bank wants to know how much of that cost will be covered by the law firm's own assets — in other words, how much equity (or debt-to-equity ratio) the firm will have in the asset.

As a side note, it has been said that law firms often need working capital loans. Technically, the advance of funds under a loan does not change the working capital. The more correct statement is that the loan is being made to help the law firm meet its liquidity or cash needs. The bank must be assured that there is sufficient equity in the law firm to repay the loan in accordance with the loan terms.

In an age when stolen credit card information and stolen identities command today's headlines, it's important to be vigilant and monitor your credit reports. That said, don't forget the basic factors of quantitative and qualitative measures. These are vital tools banks use to determine your creditworthiness.

ABOUT THE AUTHOR

Ed Poll, JD, MBA, CMC, principal of LawBiz® Management, is a preeminent coach, law firm management consultant and author. He is a thought leader in strategic planning, profitability analysis and practice development, coaching and consulting with lawyers.

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