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ON MANAGEMENT

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Paid-in Capital

Ways to manage your firm's capital requirements

It's a simple proposition: A law firm needs capital in order to conduct business. Capital is required to fund operations, acquire fixed assets, and make the necessary investments in personnel and practice development. Yet it's the management decisions that surround this simple proposition that are often enormously complex. How does a firm fix the amount of capital that partners must contribute, and what mechanism should it use for such contributions?

To understand the issues, let's start with the big picture: A firm's capital structure represents the way in which it meets its capital requirements. To meet their needs, law firms can potentially draw on several sources, including bank loans (both long-term loans, and short-term lines of credit or "revolvers"); earnings not yet distributed to partners; and permanent paid-in capital.

In the sense that it's being used here, paid-in capital refers to the permanent equity investment contributed by partners in a lump sum or as a holdback from current income. Such a holdback is often referred to as a "haircut" or "internal tax."

Permanent paid-in capital — often supplemented with long-term bank loans — is generally used by firms to fund fixed asset purchases, such as leasehold improvements and capital equipment, and strategic investments. Cash generated by depreciation and other non-cash expense items is also available for these purposes (e.g., the write-off required when a firm relocates to new offices, leaving behind unamortized leasehold improvements). At the same time, firms typically use undistributed earnings and short-term bank lines to fund current operations.

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Capital needs

The most important aspect of any capital policy is whether or not the firm is adequately capitalized. To make this determination, commercial bankers often measure a firm's paid-in capital as a percentage of revenue, assets, and inventory. So long as these percentages fall within the normal range for firms of comparable size and practice configuration, the bankers should be satisfied.

It's difficult to generalize about what is adequate capitalization, but at most firms aggregate permanent paid-in capital represents: about 5–10 percent of annual revenue; about 50–75 percent of net fixed assets; and about 10–25 percent of the current inventory of accounts receivable and unbilled time. In my experience, if your firm's ratios fall within these ranges, it is probably adequately capitalized.

But there is more to adequate capitalization than conformity to industry-wide accounting ratios. For instance, you should ask whether your firm's resources are stretched when it's required to pay down its short-term credit line. Is your firm in the midst of a major capital improvement program to replace aging equipment or move into new space? If you answered yes to either question, your firm should review its capital policy to see whether an infusion of additional permanent capital makes sense.

Partner contributions

Some firms require each partner to contribute a fixed-dollar amount to paid-in capital as a condition of admission to the firm. While this keeps things simple, this approach fails to recognize significant differences among firm members in terms of their overall contribution to the firm, income levels, and financial resources.

As a result, most firms have moved from a fixed-dollar requirement to a pay-related approach that requires capital contributions in direct proportion to a partner's annual compensation. Such annual contribution amounts generally range from 4 percent to 7 percent of compensation. Some firms apply this percentage to base compensation only, while others also apply it to bonus compensation.

At the same time, a few firms use a progressive approach requiring smaller percentage contributions, e.g., 4 percent, from partners at lower income levels and larger percentage contributions, e.g., 7 percent or more, from partners at higher income levels.

Because capital contributions are not tax deductible, the annual contribution represents income taxed but not received. This can be a significant financial burden for partners with significant ongoing cash needs.

Take, for example, the case of a hypothetical partner with annual compensation of $500,000 and annual federal, state and local taxes totaling $200,000. A 6 percent annual haircut ($30,000) would reduce this partner's after-tax distributable income by 10 percent, from $300,000 to $270,000. While it may be difficult to sympathize with someone at that income level, a 10 percent reduction in take-home pay at any income level is meaningful and cannot be disregarded.

In the interests of balance and fairness, many firms place a cap on the total amount of paid-in capital a partner is required to contribute. As above, these amounts can be a fixed-dollar amount or can be based on a partner's income level. At some firms, this upper limit amounts to about 50 percent of a partner's current annual income. Once the permanent paid-in capital account reaches this level, no further contributions are required.

Contribution methods

There are many different approaches to collecting capital contributions. Some firms require contributions to be made in a lump sum upon admission to the firm, while others permit contributions to be made over time. Still other firms combine the two approaches, coupling an immediate cash contribution with an ongoing contribution requirement to be withheld from current income. Where an immediate cash contribution is required, many firms arrange for new partners to borrow the amount from the firm's commercial bank.

Collecting from lateral partners

Lateral acquisitions present unique — and occasionally intractable — capital contribution collection issues. As a matter of policy, lateral partners should bring their capital accounts up to required levels as promptly as possible after joining their new firm. A capital investment binds them more closely to the new firm, not only in their own eyes, but also in the eyes of their new partners.

At one Am Law 100 firm, each lateral partner is required to reach his or her target contribution amount by the end of the third full calendar year following date of admission. The contribution may be made either in cash or ratably through holdbacks from current income until the payment due date.

It should be noted that this approach generally results in a holdback percentage significantly higher than for other partners. Take, for example, the hypothetical partner earning $500,000 a year at a firm that requires paid-in capital equal to 50 percent of a partner's annual income. If the partner joined the firm laterally at June 30, 2005, he or she would be required to accumulate $250,000 in paid-in capital over the 42 months ending December 31, 2008 — a rate of about $72,000 for each 12-month period, or more than 14 percent of annual income (and a staggering 24 percent of hypothetical after-tax income!). Most partners would find that burden impossible to achieve without resort to either capital received from their former firm or personal borrowing.

Some laterals choose simply to turn over to their new firm distributions of capital from their former firm, but this is increasingly difficult as firms tighten their policies with respect to capital distributions to withdrawing partners.

Capital policies can have an important impact on a firm's ability to recruit lateral candidates. For competitive reasons, most firms want capital policies that are no more burdensome than capital policies at competing firms. Paid-in capital per equity partner tends to be higher at larger and more profitable firms — well into six figures in many cases.

Three Objectives Your Capital Policy Should Meet

1. Meet the firm's needs for cash to fund capital expenditures and repay long-term debt — the firm's CFO determines the amount.

2. Satisfy the firm's commercial bankers — the bankers make this judgment.

3. Glue the partnership together — the firm's management makes this decision by setting capital requirements high enough to give firm members a real sense of investment and ownership. — R.G.

Returning capital

Firms are making it increasingly difficult for departing partners to leave with the full amount of their capital accounts. While many firms immediately distribute capital to retiring partners who withdraw under friendly circumstances, e.g., those who move to a client, these same firms often make it difficult for partners who jump to competitors to extract capital. Under such circumstances, it's not unusual for firms to spread out the return of capital over a five to seven year period.

Paying interest

My own view is that firms should pay interest on capital, but I'm in the minority. Very few firms do so. In fairness, firms that pay interest on capital are simply reallocating a portion of their income based on capital — rather than practice — contributions of partners. Most firms argue that the opportunity to share in the firm's profits is sufficient return on a partner's capital account.

In structuring a capital policy, remember that you have at least three constituencies to satisfy — the firm itself as a consumer of capital, your bankers, and your partners — with the first two taking priority over the third. Balance these interests wisely and equitably, and my bet is that your capital policy will serve your firm's interests well in the long run. LFI