How banks assess the credit worthiness of Law Firms

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When reviewing a new request for credit or when performing a periodic review of a law firm who is already a client, commercial banks typically consider more than just the firm's financial statement. Everything from the type and reputation of the firm to its exposure to industry consolidation or changes in the economic cycle to whether there's been a change in the top 10 clients or top 10 billing attorneys also are considered.

Of course, there are the natural questions you'd expect:

- Does the firm distribute more than it makes in a given year?
- What are the funds being used for?
- Is there a portion of debt that does not revolve and if so, would it be prudent for the firm to reduce that amount over time and/or consider hedging interest rate risk associated with long term borrowings?
- Does the firm need a letter of credit to back its lease payments?
- To what extent has the firm retained capital throughout the years?
- Do the Partners/Shareholders provide personal recourse under the firm's loan(s)?
- What is the legal form of organization? (e.g. Partnership, PC, LLP, LLC, etc.)

Then there are further questions that will help the bank understand the long-term stability of the firm such as how much hiring is taking place or how many employees are leaving. What is the firm's strategic approach to managing expenses? Is revenue concentrated among a few clients and how are individual practice groups performing? Understanding the strategy of the firm as well as potential obligations helps to round out the picture. Questions such as:

- Is there an adequate succession plan in place?
- Is the ownership of the firm equitably distributed based on partner billings?
- What is the firm's Capital Program for its Partners (or Shareholders) and is there a need for a Capital Loan Program?
- Is there a pension in place and is it adequately funded?
- Are there significant retirement payments owed to founding partners and, if so, is there a reserve in place?
- What is the firm's go-to-market approach as it relates to its proportion of Equity Partners, Income Partners, Associates, etc.

There a few factors that help banks to identify the healthiest firms. Strong firms *generally*:

- Manage cash flow well.
- Limit distributions to that year's pre-distribution net income.
- Tie Partner/Shareholder compensation to realization rates and actual collections.
- Manage the client base to avoid continual and excessive billing disputes and extreme seasonality.
- Have operating cash flow sufficient to cover annual needs and seek term debt to finance longer term.
- Use lines of credit to bridge intra-year seasonal timing differences between cash distributions and cash collections and then reduce line borrowings to $0 for a sustained period during the year.
- Have strong collection practices and realization rates for accounts receivable and work in process (generally 85% or higher).
- Have consistency and moderate-to-low concentration in top clients year over year (unless the work of the firm is more 'one time' in nature such as class action, plaintiff personal injury, etc).
- Have diverse sources of revenue across practice groups.
- Are more likely to remain independent or acquire talent or another firm vs. being acquired.
- Use term debt tied to a specific event (such as tenant improvement expenditures for an office move) and amortize over a reasonable period of time
- Utilize fraud protection services on operating accounts and remote deposit and/or lockbox services to speed collection of receivables.
- Optimize revenue and expenses through a healthy balance of Equity and Income Partners and Associates.

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