Funding for Law Firms – a look at the options

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Howard escaped from Grant Thornton UK LLP in 2008 where he had been a partner for over 25 years to establish his own boutique practice. During his time at Grant Thornton he was head of professional practices for the North West and head of family businesses for the UK. At Grant Thornton he had a variety of roles including office Managing Partner, North West regional marketing partner and membership of the partners appointments panel. Howard specialises in advising mid market professional practices and family businesses. In 2002 he won the CBI's national award as "Best Business Adviser“.

Howard's focus is providing "special projects" advice to firms with up to 20 partners. His experience extends from highly profitable sole practitioners to advising 3 of the top 100 law firms. Recent assignments have included sales of law firms, partnership disputes, fund raising, LLP and ltd company conversion, ABS conversions, sales and acquisitions.

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Barry Wilkinson helps medium-sized Law Firms, to improve their business performance, helping successful ones grow turnover, profits and client loyalty, and turning round the "stressed but not distressed"

Barry is the founder of Wilkinson Read & Partners, an Executive Committee member of the Law Management Section, Past President of CIMA (Leicester) and a member of both the Institute for Turnaround and the Association of Partnership Practitioners and the author of Cash Flow Management for Law Firms .

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Introduction

Agenda

- Funding needs
- Capital structure
- Sources of finance
- Banking considerations
- LLP or Ltd co
- Pensions & property ownership

- Firms outside top 50 – indeed 1-20 partners
- Case study approach – RT & Co

SRA – financial viability indicators

- Drawings in excess of profits
- Borrowings in excess of net assets
- Heavy dependence on high overdraft borrowing
- Inability to measure or control financial performance
- Over dominant senior/managing partner
- Lack of transparency of financial performance
- Narrow focus on single type of work
- Weak billing & cash collection processes

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Funding need

Integrated forecasts – no substitute

- Integrated forecasts – cash, P&L B/S
- Funders expectations
- Bottom up & department by department
- Rigorously challenge
- Zero base for overheads
- Partner admissions & retirements & Capex
- Include contingency & be conservative – outperform
- Monthly rests but for how long?

Lock up

- Funds tied up in debtors and WIP
- Needs to be funded by partner cash or the bank
- Increasing lock up = less available to partners and/or more needed from the bank
- Growing practices are likely to need more funding:
  - Meet salaries and O/Hs that are paid before fees received
  - Credit control may slip
  - Growth may come from being price competitive = lower profits
- Typically measured in number of days

WIP

- WIP is often the key
- WIP – contingent or otherwise difficult to fund
- Process driven contingent work
  - Determining its “true” value
  - Often excluded from accounts for tax reasons
  - 3 sets of accounts!!
- Accuracy of WIP records in collegiate type practice?

RT & Co - Lock up calculations

Fee income	2,500,000	2,500,000
Contingent WIP	0	300,000
WIP	500,000	500,000
Accrued income	350,000	350,000
Debtors from clients	285,000	285,000
Disbursement debtors	75,000	75,000
	1,210,000	1,510,000
In days	177	220

Reduction by 14 days = £100,000

KPIs – reported & monitored monthly

- Billing
- Work done (chargeable hours)
- Recovery
- Productivity/utilisation
- Lock up

- By partner
- By fee earner
- By department

- Month & year to date
- Against budget (& previous year)

Capital structure

Partner capital

- Need to distinguish between types

Fixed capital	200,000
Current accounts	85,000
Tax provision	75,000
	360,000

- Current account to be freely withdrawable
  - So sufficient bank facilities needed
  - Fixed capital set sufficiently high
- Fixed capital often borrowed personally
- Tax provisioning policy – complex but highly recommended
- Drawings policy
  - Linked to anticipated profit share & realistic forecasts
  - Regular monthly amounts (like a salary)
  - Surplus drawn after accounts available

RT & Co Balance sheet to include WIP

Fixed assets	75,000	75,000
Current assets		
Contingent WIP	0	300,000
WIP	500,000	500,000
Accrued income	350,000	350,000
Debtors from clients	285,000	285,000
Disbursement debtors	75,000	75,000
	1,210,000	1,510,000
Current liabilities		
Trade creditors	10,000	10,000
Bank borrowing	**500,000**	**500,000**
	510,000	510,000
Net current assets	700,000	1,000,000
Net assets/Partner capital	775,000	1,075,000

RT & Co - implications

	Points	Existing capital	Add WIP	Revised capital	Revised capital
Alice Arnold	80	150,000	60,000	210,000	**215,000**
Brian Barlow	100	250,000	75,000	325,000	**268,750**
Cathy Clarke	60	75,000	45,000	120,000	**161,250**
David Dawes	80	150,000	60,000	210,000	**215,000**
Edward Eagle	80	150,000	60,000	210,000	**215,000**
	400	775,000	300,000	1,075,000	1,075,000

Points system – capital and "dividend"

	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5
Partner 1	100	100	100	100	100
Partner 2	60	70	80	90	100
Partner 3	100	90	80	70	60
Partner 4	0	0	50	60	70
	260	260	310	320	330

	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5
Partner 1	38.5%	38.5%	32.3%	31.3%	30.3%
Partner 2	23.1%	26.9%	25.8%	28.1%	30.3%
Partner 3	38.5%	34.6%	25.8%	21.9%	18.2%
Partner 4	0.0%	0.0%	16.1%	18.8%	21.2%
	100.0%	100.0%	100.0%	100.0%	100.0%

Sources of finance

Options

- Internal possibilities
  - Reduce lock up
  - Retained profits
  - Tax retention / reserve
  - Partner capital
- External
  - Traditional sources
  - Non traditional
  - Equity

External

- Traditional – banks and financial institutions – see below
- Non traditional
  - Invoice discounting difficult & regulatory issues
  - Debt crowdfunding possible
- Equity
  - PE, VC highly unlikely for those outside top 50
  - In ABS era private individuals possibly but why?
  - Equity crowdfunding possible just
  - 3-5 year time frame
  - Process driven practice rather than collegiate
  - Profits to financiers limit those to partners → recruitment

Banking considerations

Borrowing

- Can be personal or in the practice
- If in practice LLP and Ltd Company are better
  - Banks ability to take a charge
  - Partners can limit their risk (but personal guarantees)
- Personally for capital
  - Off balance sheet
  - Banks will look to both personal assets AND underlying practice
  - Will look at lending in “the round”
  - Try to have a separate bank from that for the practice
- Tax rules
  - 25% of profit share as risk capital
  - Can be guaranteed by the practice

Bank criteria

- Gearing – 1:1 – also a partner risk issue
- Security - varies but 30% to 50% debtors & WIP
- Debt to fee income < 40%
- Personal Guarantees??!! – restrict if possible
- Cash cover (debt servicing) -120%
- Interest cover – at least 2 times but less used
- Others but vary from bank to bank
- Funding document different from “business plan”

RT & Co – gearing capacity

Fixed assets	75,000	75,000
Current assets		
Contingent WIP	300,000	300,000
WIP	500,000	500,000
Accrued income	350,000	350,000
Debtors from clients	285,000	285,000
Disbursement debtors	75,000	75,000
	1,510,000	1,510,000
Current liabilities		
Trade creditors	10,000	10,000
Bank borrowing	**500,000**	**800,000**
	510,000	810,000
Net current assets	1,000,000	700,000
Net assets/Partner capital	1,075,000	775,000

Partner implications

	Alice Arnold	Brian Barlow	Cathy Clarke	David Dawes	Edward Eagle	Total
Profit share	20%	25%	15%	20%	20%	100%
Points equivalent	80	100	60	80	80	400
Existing capital	150,000	250,000	75,000	150,000	150,000	775,000
WIP uplift	60,000	75,000	45,000	60,000	60,000	300,000
	210,000	325,000	120,000	210,000	210,000	1,075,000
Revised capital	215,000	268,750	161,250	215,000	215,000	1,075,000
(Contributed)/drawn	(5,000)	56,250	(41,250)	(5,000)	(5,000)	0
Revised capital	215,000	268,750	161,250	215,000	215,000	1,075,000
Bank borrowing	(60,000)	(75,000)	(45,000)	(60,000)	(60,000)	(300,000)
Geared capital	155,000	193,750	116,250	155,000	155,000	775,000
(Contributed)/drawn	(5,000)	56,250	(41,250)	(5,000)	(5,000)	-
Bank funded	60,000	75,000	45,000	60,000	60,000	300,000
Capital movements	55,000	131,250	3,750	55,000	55,000	300,000

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LLP or Limited company

Limited company

Advantages

- Recognised vehicle for M&A activity
- Relatively low set up and operational costs
- Potential goodwill extraction if sale to 3rd parties
- Retained profits taxed at corporate rates – to repay borrowing
- Better structure for share incentives
- Better understood for true ABS

Disadvantages

- Inflexible succession planning
- Administration & documentation
- Benefits in Kind regime – particularly cars
- Potentially expensive:
  - NIC
  - PAYE
  - Cash flow
- BUT New dividend tax rules

Tax position – tough call!!

	Remuneration		Dividend	Interest or rent	LLP	
	40% full NI	40% lower NI	32.5%	40%	40% full NI	40% lower NI
Profits	1,000	1,000	1,000	1,000	1,000	1,000
Remuneration	(879)	(879)				
Employers NI at 13.8%	(121)	(121)				
Interest on directors loan				(1,000)		
Subject to corporation tax	0	0	1,000	0		
Corporation tax at 20%	0	0	(200)	0		
Dividend paid	0	0	(800)	0		
Profits retained	0	0	0	0		
Personal income	879	879	800	1,000	1,000	1,000
Income tax	(351)	(351)	(260)	(400)	(400)	(400)
NI	(105)	(18)	0	0	(90)	(2)
Net proceeds	422	510	540	600	510	598
Effective tax rate	57.8	49.0	46.0	40.0	49.0	40.2

Ignores - £5,000 dividend allowance and Class 2 NI

Other tax issues

- Tax on profits retained on exit

	CGT	
	20%	10%
Retained profits	1,000	1,000
Corporation tax at 20%	(200)	(200)
	800	800
Less CGT	(160)	(80)
Net proceeds	640	720
Effective tax rate	36	28

- Tax on incorporation
  - CGT & Stamp Duty – relief if same before & after
  - Release of overlap relief
  - Goodwill “trick” no longer available unless sale to 3rd party
- Will dividend extraction be attacked?
- Potentially no employer NICs for fixed share partners
- Pensions - Ltd able to control income for restriction of £40k relief if > £150k
- No Employment Related Securities for new partners in LLP
- Difficult to go back tax efficiently

Summary

- LLP or Ltd no brainer v unlimited partnership
- No simple answer
- What is important? Flexibility v. Incentivisation
- Tax marginal
- Rule of thumb
  - LLP if draw out all profits
  - Ltd if significant borrowings to repay

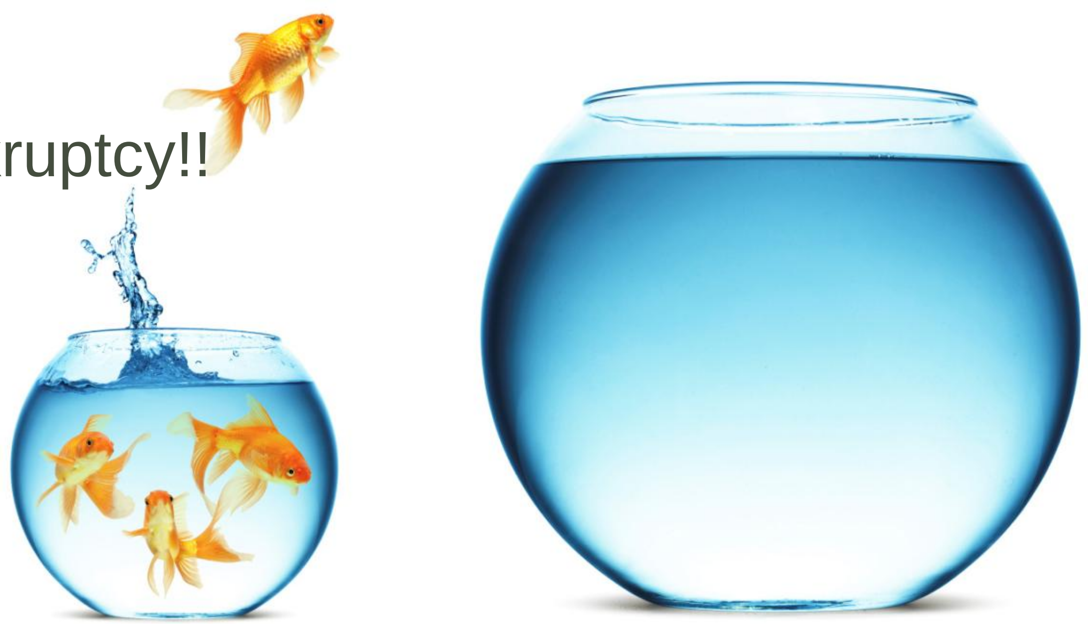
Pensions & property ownership

A personal view

- Genuine self administered arrangements
- Changes reinforce firm belief in pension planning
  - Tax benefits
  - Security for the individual
  - Potential cash release of money in existing properties
- Summer 2015 budget
  - Lifetime limit £1m
  - Restricted contributions if income >£150k
  - 3 year carry forward relief – potential £160k
- Complex but worth it and take advice

Tax benefits

- Tax relief on contributions at marginal rates
- But make sure sufficient income taxed ideally at 40%+
- Tax free growth
- 25% of fund available as tax free lump sum
- Fund is IHT free – until age 75
- If death post 75 – 45% tax or marginal rate
- Added benefit that usually protected in a bankruptcy!!



Commercial property (1)

- Often a sensible approach
  - Rental returns of 5%-10%
  - Tax free growth
  - Property purchased at 40%+ discount
  - Control of destiny & common interest
- Use existing funds – but care over transfer values & GAR
- Can borrow upto 50% of fund
- Open market rent to be paid – tax deductible & tax free
- Partner issues
  - Can buy <100%
  - Need for agreement with partners on exit & % share arrangements

Commercial property (2)

	Scenario 1	Scenario 2
Initial contribution net of BR tax	128,000	128,000
Tax refund into SIPP	32,000	32,000
	160,000	160,000
Transfer of existing funds	0	140,000
	160,000	300,000
Borrowing 50% of fund	80,000	150,000
Property capacity	240,000	450,000

Note: if property already owned then existing fund released in cash

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