

## Debt and the Small-Firm Lawyer:

### "Be careful out there!"

Many small-firm lawyers have clients with limited resources. Those who aren't firm about payment often end up with cash flow problems caused by excessive unbillable time, high accounts receivable and exorbitant write-offs.

Some try to alleviate their problem by establishing a bank line of credit. However, they can propel themselves into even deeper financial problems if they fail to carefully assess the ability of their practice to carry the debt.

Let's say your bank offers a line of credit of \$20,000.00 with interest at 8% per annum. If you, draw down the full amount, how long will it take to pay it back?

We'll make a few assumptions about the **average** performance of your practice:

- your expenses (including bad debts) are 55% of your billings
- your average tax rate is 35%
- your unbilled disbursements are more or less steady
- you don't need any capital investments
- you don't expect any huge cash windfalls
- you have no other sources of income
- you need to take home \$3,500 per month, after taxes

The table shows three monthly billings scenarios, \$12,000, \$15,000 and \$25,000.

		Scenario 1	Scenario 2	Scenario 3
1	Billings	12,000.00	15,000.00	25,000.00
2	Pre-tax profit	5,400.00	6,750.00	11,250.00
3	After-tax income	3,510.00	4,388.00	7,313.00
4	Take-home	3,500.00	3,500.00	3,500.00
5	Available for debt repayment	10	888	3,813.00
6	Months needed to retire debt	Forever	25	6
7	Repayment as a percentage of #3	N/A	20.2%	52.1%

On these assumptions, a \$12,000 per month practice cannot sustain a \$20,000 line of credit.

Even at \$15,000 per month, the \$20,000 line is still too much: you would be able to pay off the line in two years, but you would have to discipline yourself to pay the bank over 20% of your net profit every month.

Even at \$25,000 per month, it would take you 6 average months to pay back a \$20,000 line of credit. At that level of billing, you would not likely be happy taking home \$3,500 a month, but to meet your target you would have to discipline yourself to pay the bank more than you pay yourself.

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You might try to justify the line of credit with the argument that your billings and your profit are bound to go up. But that's a dangerous game; if things don't turn out as you expect, you will be in deep trouble.

So what should you do? Start by analyzing the swings in your cash flow. Get **overdraft protection** to protect yourself so that if you have a bad month or two, you're covered. If you have several poor months, tighten your belt by

- focussing, at least for a while, on work you can bill and collect quickly
- eliminating unnecessary overhead
- reducing your draws

When your cashflow recovers, pay off the overdraft before your resuming your old level of draws.

If you have a line of credit, only use it to accelerate receipt of extraordinary bumps in cash flow that are guaranteed (for example, a settlement that has been reached and you are waiting for the cheque or a bill has been sent to a good client who always pays within 30 days). Pay the line of credit off as soon as the money comes in.

And don't use the overdraft to surreptitiously increase your draws until you are sure your monthly average collections have permanently increased.

The moral of this article? Just this, from a long-dead cop show called Hill Street Blues: Be careful out there!

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