2015

PLANNING FOR YOUR FINANCIAL SUCCESS: PRACTICE POINTERS

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Recommended Citation
PLANNING FOR YOUR FINANCIAL SUCCESS:
PRACTICE POINTERS

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INTRODUCTION

The demand for legal services has been steadily declining since the financial crisis in 2008.1 At the same time, the United States is producing approximately 44,000 new attorneys each year.2 Currently, there are almost 1.3 million lawyers in the United States.3 As a result, operating a law practice at a profit has become even more challenging. A solid understanding of business is required for every practitioner to succeed.

I. STARTING YOUR PRACTICE: DEVELOP A BUDGET

A basic principal of successfully starting any business is a realistic budget. In theory, only a computer, a cell phone, and a malpractice insurance policy are required. Practically, however, more is needed. Starting a practice is an investment. But, renting one thousand square feet of Class A office space and purchasing a brand new mahogany desk are unnecessary, and, perhaps, foolish luxuries for a new solo practitioner. The starting point is to identify the unavoidable costs that must be incurred and the anticipated timing of those expenses. Then,

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3. Jeff Jacoby, US Legal Bubble Can’t Pop Soon Enough, BOSTON GLOBE (May 9, 2014), available at http://www.bostonglobe.com/opinion/2014/05/09/the-lawyer-bubble-pops-not-moment-too-soon/qAYzQ823qpfi4GQl2OiPZM/story.html. In 2009, there were 2,165 bar exam passers in Massachusetts, while there were only 715 estimated annual job openings. Id.
sources of capital must be procured. While a budget is merely a planning tool, and must be malleable, it is critical to a successful start.

A. Expenses: How Much Money Do I Need?

1. The Tangibles

First impressions are important. Clients are looking for confidence and credibility. The moment that a client steps through the door, the client begins to form expectations about the quality of the services that she may receive. A serious lawyer needs a suitable office.

Most solo practitioners lease office space. Consider whether your practice needs to be near the courthouse, near certain clients, near your home, or near other lawyers. Do you need high visibility or to be near public transportation? To determine how much space you need, consider whether you intend to hire staff or will need a conference room or a kitchen. Does the space have the potential for you to expand your office space as your practice grows?

After identifying your office space needs, you need to negotiate your lease. There are four ways that rent is typically structured: straight rent, single net, double net, and triple net. Single net is straight rent, plus real estate taxes. Double net rent is straight rent, plus real estate taxes and insurance. Triple net rent includes straight rent, plus taxes, insurance, and maintenance. Certain landlords may also require a tenant to pay common area charges. In addition to rent, be sure to understand what, if any, other services are included in the lease. For example, some or even all utility expenses may be the tenant’s responsibility. The lease may, or may not, include other services such as cleaning, waste removal, signage, and maintenance.

There is at least one lease term that the new solo practitioner should approach with caution: a personal guaranty. Attorneys that are unincorporated will likely execute a lease individually by default. Even when an attorney strictly adheres to corporate formalities, she may still be required to guaranty payment of the lease because a new, small law practice has few assets and presents a credit risk to the landlord. Commercial leases are usually three to five years. If the lease provides for $500.00 per month rent for three years, then the initial cost of the lease is $18,000.00. Although incurring the debt may be unavoidable, be sure to at least understand your potential personal financial exposure.

Furniture is, of course, also required to create a professional office. It is not, however, necessary to spend a large part of your business on this component. Used furniture is often readily available at an economical price. In addition to consignment stores, consider asking
your bar association if there is an attorney retiring or a firm down-sizing. Some of the furniture expense can also be delayed so long as you have the bare necessities to get started.

Every law office needs certain basic pieces of equipment and supplies. Most equipment can be purchased or leased; opinions differ regarding which is the “better” option. The critical rule is: do not finance something longer than its anticipated useful life. While long payment terms may seem preferable while your practice is getting off the ground and has limited cash flow, it can end up costing you more than you expected in the end. In addition to paying interest on the purchase, the equipment may need to be replaced before you have finished paying the bill.

Maintenance contracts may also be available for certain pieces of equipment. A common example is a photocopier. Some retailers will offer a maintenance contract including free maintenance and supplies (e.g., toner) with the purchase of a new copier. These contracts can insure that your equipment is functioning properly and avoid headaches later as you attempt to repair the machine yourself. However, these contracts can be expensive. And, your budget may only allow for the purchase of a used copier.

Accurate recordkeeping from the beginning is critically important for tax purposes. Once a year, businesses are generally required to pay taxes on personal property to the local municipality. This may require, at a minimum, a detailed itemization of each piece of equipment and furniture and its value. The purchase of equipment and supplies is also, generally, deductible for income tax purposes. It is significantly more time-consuming to attempt to organize this information after-the-fact from old credit card bills or the check register. This is time that could be spent otherwise working on cases and generating revenue. It is also significantly more expensive to pay a bookkeeper or accountant to do this chore from your notes. To save precious time and resources, keep organized and accurate records from the start.

2. The Intangibles

Licensing is not optional. In Massachusetts, the annual fee for a bar license is currently $220.00. In Connecticut, lawyers are required to pay an occupational tax, which was $565.00 per attorney in 2013. Even after being admitted to the bar of the state, there are fees associated with

5. See CONN. GEN. STAT. §§ 12-30, 51, 81b, and 51-81d.
applying to be a member of the federal bar for each district.\(^6\)

Malpractice insurance is also not optional. Any attorney practicing law is at risk of being sued for malpractice.\(^7\) Insurance policies are complex and provide varying types of coverage. The purpose of a malpractice insurance policy is to limit your personal exposure if you are successfully sued for making a mistake. For the purposes of this Article, we will only note that there are two basic financial considerations to determine for your budget: the deductible and annual premium. Like other types of insurance, choosing a policy with a relatively low deductible will result in a higher premium.

Additional insurance may also be a wise investment, even while your firm is in its infant stage, for the personal protection. Most businesses carry general liability insurance; all employers must carry workers compensation insurance. Disability insurance is also advisable. A disability insurance policy would compensate you in the unfortunate event that you were injured in such a way that you were out of work for any extended period of time and unable to work.

There are several other intangible expenses worth considering in your budget and in your overall business plan. One of the new, solo practitioner’s first tasks is to let new and potential clients, other attorneys, and the world know that you are in business. Traditional advertising can be costly; but, producing business cards, letterhead, and envelopes with your firm’s logo may be prepared relatively inexpensively. The decision where to invest limited funds to grow your business will depend significantly on the nature of your practice. As noted above, creating a professional image is important to attract new clients.

What about a website? It seems that most clients will expect, at a minimum, a one-page website with basic information about the attorney, her practice areas, and contact information. If you decide to have a website, there are several issues that will need to be resolved: who will build the site? Who will host and maintain the site once it is built? Should you invest in paid Google advertising or search engine optimization? Consider starting with a free option such as Facebook.

Networking is essential for solo practitioners and small firms to generate business. There seem to be an endless number of bar

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associations and professional organizations related to the practice of law. There are even more such groups to which your potential clients may belong. As you start your new firm, identify a couple specific groups in which you wish to participate. Merely joining groups will likely not generate many leads; however, becoming an active member and leader in a group will provide the opportunity to create new relationships that will, hopefully, eventually result in income. It is also noteworthy that, as a general rule, there is an annual membership fee for each of these groups that should be included in your budget.

Plan to participate in a minimum number of continuing education courses each year. Many courses are offered at a reduced price for new lawyers; there are also sometimes scholarship opportunities for new practitioners. CLE’s are important to learn many basic practice skills and also present a networking opportunity.

3. Technology

The single largest initial expense for a new solo practitioner is often technology. Today, it is, quite simply, unthinkable to attempt to practice law without a computer, a printer, a scanner, and an Internet connection. Technology is necessary to communicate with existing and potential clients, opposing parties, and the court. Practitioners have become almost totally dependent upon technology; we use it to prepare almost every document from letters to pleadings and for almost all legal research. Nothing will bring a bustling law firm to a standstill like a computer-related problem. And when the firm is not operating, it is not generating any income to pay the bills.

Purchasing a computer, printer, and scanner is almost always a matter of personal preference. Consider how much storage you may need as you start your practice and whether any compatibility issues are anticipated. Regardless of the size of your practice, a solid and reliable back-up system is absolutely essential.

Many basic business functions of a small law practice can be accomplished with relatively inexpensive software. In addition to a word processor, many attorneys use an accounting program to manage their business. There is a variety of accounting software programs

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8. MCLE offers most of its courses at a reduced rate for lawyers admitted for no more than three years.

9. The federal court system is entirely online and accessible through Public Access to Court Electronic Records. See PACER, www.pacer.gov. All documents related to federal cases are filed and transmitted electronically through the Case Management/Electronic Case Files system.
available at almost all price points. Some programs are specifically designed for attorneys and include practice management tools such as conflict checking. Some solo practitioners and small firms find that these types of programs are cost-prohibitive and rely instead on a basic “shrink-wrapped” accounting software program. However, as the practice grows, this may become a necessary expense.

Certain areas of practice will also require specialized software. For example, bankruptcy attorneys usually have to purchase a software program to prepare the Petition, Schedules, and Statements required to be filed with the Bankruptcy Court. This software has an initial cost of approximately $2,000.00 and annual maintenance fee of about $500.00-$700.00. Your budget should also address whether your practice will have an annual or monthly expense for online legal research tools.

Providing for the adequate protection of your clients’ personal and confidential information is an additional necessity that may increase your initial technology expenses. Massachusetts has possibly the strictest data security laws and regulations in the United States. Among the requirements imposed under the Massachusetts Data Security Law, are several regulations related to authentication, restricting access, encryption, firewall, and virus protection.

In addition to the (long) list of costs identified above, there are personal living expenses. A solo practitioner must be prepared to not receive a paycheck for a period of time until the firm can generate enough income to make such a distribution. Your budget must address how you pay your rent or mortgage, buy food, and, if necessary, support your family in the interim.

B. Capital: Where Do I Get the Money?

As noted above, the amount of capital required to start a practice will depend on your anticipated expenses. There are several potential sources of cash from which to draw to start a firm. We will review some of the benefits and risks associated with a few options.

1. Self-Financing

Sometimes an attorney may look to assets she has already accumulated to fund opening a practice. Investing your assets, such as savings, in your practice may be the least expensive source of capital; there is no repayment of interest and no pledge of collateral. However,
there are several potential consequences to be aware of. Liquidation of retirement accounts prematurely will likely result in a substantial penalty, reducing the value of the liquidated account.\textsuperscript{12} There are also often income tax consequences to liquidating stocks or retirement accounts.\textsuperscript{13}

Another self-financing option is to use any equity that you may have in your home by obtaining a mortgage or home equity loan. Interest paid on account of loans secured by your home is currently deductible for income tax purposes,\textsuperscript{14} however, granting a mortgage will expose you to the risk of foreclosure if the practice fails for any reason, including those beyond your control.

2. Credit Cards

Credit cards are convenient and useful for short-term financing. Many credit cards offer points, cash back, and other bonuses. Credit card debt is also dischargeable in bankruptcy.\textsuperscript{15} However, credit cards often have very high interest rates. In their contracts, credit card companies also almost always provide that the signor on a corporate card is also personally liable. Often people fail to realize that by using a corporate card that they are exposing themselves to personal liability.

3. Bank Loans

Traditional bank financing may be an option for initial capital as well as for working capital. Bank loans are based upon character, capacity, capital, and collateral; in short, they are based upon creditworthiness. Law firms typically have few hard assets to which a bank can look to for collateral to secure repayment of the loan. Practices that have been operating for a period of time will have accounts receivable that may be sufficient to secure a bank loan. New and small firms, however, will have a more difficult time obtaining credit without additional security. Specifically, a bank would likely require a personal guaranty of the loan. Depending on the attorney’s creditworthiness, the bank may also require a mortgage on the attorney’s home to secure repayment. Whether a small or large firm, the benefit of partners is that each individual attorney can mitigate her risk.

4. Borrowing from Friends & Family

A fourth potential source for capital is loans from friends and family members. This option can be tempting because it is likely that the terms will be much more favorable than a bank loan or credit cards. However, there are several opportunities for problems. Borrowing money from friends and family almost certainly negatively impacts the relationship. It could also create a conflict if the friend seeks your legal assistance later.

Developing an initial budget for a solo practice is an undertaking that can have far-reaching and unanticipated consequences for even experienced attorneys. Consult with an experienced attorney and accountant in advance of making any final decisions in order to be sure you understand your total exposure.

II. OPERATING & MEASURING YOUR SUCCESS

A. Getting Paid

Simply being smart doesn’t make you any money. Many highly intelligent attorneys struggle to realize financial success through their legal practice. Solo practitioners have what appear to be (at least) two full-time jobs that require a tremendous amount of work: lawyer and office manager. Too much effort dedicated to one at the expense of the other will foil chances of success. Anecdotally, it seems that new, solo practitioners struggle to keep up with the “business” side of the practice; they are focused on practicing law. The goal is to implement the proper strategies that will allow the practice to be as profitable as it can be.

1. Fee Agreements

Pursuant to Rule 1.5 of the Massachusetts Rules of Professional Conduct, all fee agreements must be in writing. While the Rule does not specify the exact terms that must be included in the fee agreement, it does require that the scope of the representation and the basis for fees and expenses must be outlined.

There are three types of fee arrangements: hourly, contingency, and flat fee. Each area of the law often adopts one of these fee arrangements as the “standard.” For example, plaintiff’s counsel in personal injury cases almost always has a contingency fee agreement with its client, however, the defendant’s attorney will likely bill on an hourly basis. Real estate attorneys, on the other hand, almost always charge a flat fee.

for a residential real estate closing. The reasons for using these different fee structures vary depending on the source of the funds available to pay the fees and competition among attorneys. Know your client’s resources.

In determining how to structure your fee arrangement with your clients: (1) read the Rules of Professional Conduct; (2) investigate the common standard in your region for the legal services to be rendered; and (3) re-read the Rules of Professional Conduct. 17

2. Billing Procedures

Typically, hourly and flat fee matters will require the client to pay a retainer. Retainers vary among firms, practice areas, and locations. Often, even where an attorney has negotiated an hourly fee agreement, and the client has given his written consent to such an arrangement, the initial retainer may be the only money that the attorney receives. Sometimes this is because the client simply cannot afford to pay; other times it is because the attorney failed to bill the client effectively.

While specific procedures may vary, the key is to get the invoice out quickly and regularly. 18 Unbilled time, commonly referred to as “Work In Progress” or “WIP,” is like inventory. It doesn’t produce revenue for the business as long as it is still on the shelf.

Most clients cannot afford to pay large legal bills. Further, as a practical matter, a client is more likely to pay small bills along the way, particularly while you are still providing them services, than one large bill after their problem is solved and the matter is concluded. This is not a criticism of the client. Rather it recognizes a fundamental fact: clients forget—quickly. They forget the desperate situation they were in and the effective way you assisted them in resolving their problems. They almost always just want to move on from their legal troubles.

Sometimes a large final bill is inevitable. In such cases, it is wise to consider whether to send a large bill that the client will almost certainly not pay or to write off a substantial amount of time and send a small bill that the client is more likely to pay? (Answer: send the invoice you believe that you can collect.) Offering discounts can also incentivize a client to pay a bill in full quickly.

There are a growing number of methods for accepting payment. Personal checks are very common, but can bounce. Credit cards can sometimes be an acceptable method, however, there is a fee for this

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18. Monthly or quarterly billing is common among law firms.
convenience, which can be about two to three percent of the charge. Credit cards can also create ethical problems for clients in financial crisis.

Delinquent accounts can be collected through traditional debt collection remedies such as suit. In some instances, the attorney may have a statutory remedy such as an attorney’s fee lien. However, debt collection can result in further expense for you. In addition to the time it takes to pursue the client, which could be spent on paying clients, there are out-of-pocket fees such as filing fees to commence an action, hiring a sheriff to serve process, and recording an Execution in the Registry of Deeds.

Ultimately, learning which cases to accept, and which cases not to, is the easiest strategy for getting paid for your time and effort.

B. Keeping Score

After developing a comprehensive and conscientious budget ahead of time, you must be able to evaluate whether the budget is working once you have opened the doors. An understanding of the numbers will allow you to modify your budget to allow you to operate profitably. There are three basic documents that will inform you of the current condition, performance, and value of your business.

1. The Balance Sheet

The Balance Sheet is a snapshot of the financial condition of the practice at a moment in time. The balance sheet is simply a comparison of current assets versus liabilities. Assets of a law practice may include cash, accounts receivable, prepaid expenses, leasehold improvements, equipment, furniture, vehicles, and other assets. Note: it does not include Work-In-Progress. The value of the assets is usually the “book value” or “historical cost” (i.e., the cost of the asset minus accumulated depreciation), not fair market value. Liabilities included on a balance sheet, such as accounts payable and bank loans, are divided into short-term and long-term debts. Equity generally consists of (1) common stock or capital invested into the business since inception, and (2) retained earnings, which are a summary of all profits or losses, which have been earned and reinvested in the company since inception. Total liabilities and equity must equal the value of the assets.

19. MASS. GEN. LAWS ANN. ch. 221, § 50 (West 2014).
2. The Income Statement

Income statements state revenue and expenses for a period of time. In essence, net income is calculated by subtracting the cost of goods and all other operating expenses from gross revenue. Income statements can be useful in comparing year-to-year performance.

3. The Cash Flow Statement

Neither the balance sheet nor income statement provides a clear picture of the sources and uses of cash; the cash flow statement provides a “cash map” that identifies any problem areas in the business’s financial health.

The cash flow statement includes three sections: cash from operations, cash from investing, and cash from financing. Operations consist of net income and depreciation, less accounts receivable and inventory (WIP), plus accounts payable and other liabilities. Accounts receivable have no “cash” value; accounts payable, however, represent value that has been received, but not paid for. A practice that has high receivables and WIP, may not be generating enough cash from the operation of the business; attorneys’ time is not being recovered. Cash from investment combines capital expenditures and proceeds from the sale of any assets. A law practice rarely receives income from the sale of any assets; it may, however, have to make capital expenditures for equipment (e.g., computers) or leasehold improvements.

Financing is the third category of cash and will highlight whether too much of the practice’s cash is coming from borrowed money, such as a line of credit, which would not necessarily be included in accounts payable under cash from operations. Finally, the cash flow statement calculates the value of the business by adding or subtracting cash from operations, investment, and financing to the amount of cash the business had at the beginning of the year. A positive number at the end of the year is a sign of a healthy, profitable business.

CONCLUSION

Private practice is a business; its primary purpose is to make money. Financial success in the practice of law, like any other business, depends on the proper balance of income and expenses and of assets and liabilities in planning and implementation.