LAW FIRM MANAGEMENT

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When should you buy or lease office space?

Like many businesses, law firms often face the quandary of whether to purchase or lease office space. While property ownership comes with several potential financial and tax benefits, it also frequently brings hassles and headaches you usually can avoid by leasing space. The correct choice will depend on your firm's current position — financial, competitive and geographic.

THE PROS AND CONS OF BUYING

One of the draws of buying your space is control of both the property and the costs. You can make substantial improvements without requiring landlord permission and avoid the risk of the landlord deciding to use the property for a different purpose. By locking in your long-term cost with a mortgage, you escape inevitable rent increases.

Location can be another reason to buy. Buying office space in an area likely to experience rising property values means you'll benefit from the appreciation and won't have to worry about getting priced out by escalating rents down the road.

Income and equity also might favor buying. If the property is large enough, you can rent out space to other tenants and enjoy additional income. As time passes, the firm will build up equity that it can later use as collateral.

As for tax advantages, you can recover the purchase price over time through depreciation deductions. If you have tenants, you can deduct repairs the year they occur and amortize improvements. And you can deduct property taxes and mortgage interest. Depending on the structure of your law firm, you might want to purchase the property in a separate entity.

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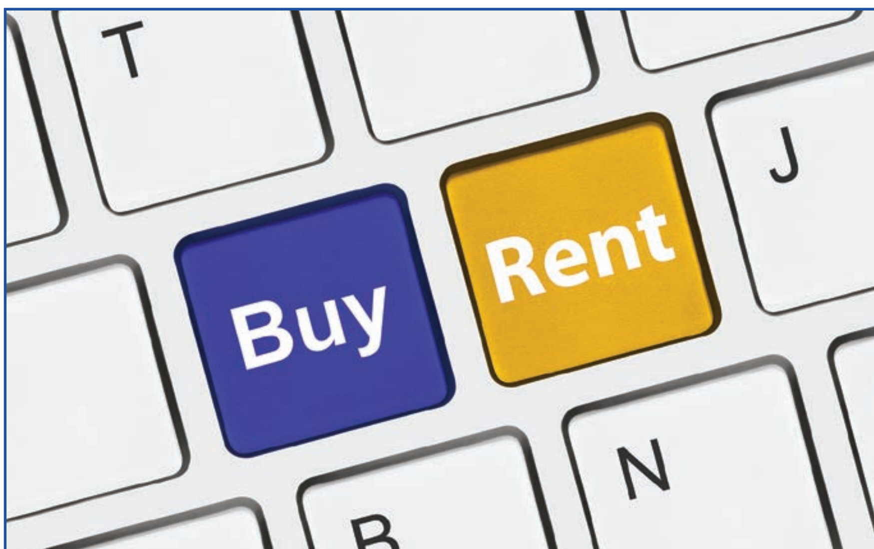
So what are the downsides? You forfeit some flexibility when you buy. For example, your upfront costs will be much higher than with leasing, including a down payment, closing costs and potentially pricey improvements. Further, if you need more space, you might have to sell the existing property and find a new property, with added costs for broker fees and the like.



Perhaps the biggest drawback is the burden of property management, which can divert you from moneymaking activities. You can always hire a property manager to handle repairs, maintenance and, if applicable, tenant issues, but that inflates your costs and eats into your bottom line.

CASH FLOW CONSIDERATIONS

Sitting on the fence about whether to buy or lease? If the major pros and cons seem to balance out fairly equally, a cash flow analysis could break the tie for you.

A cash flow analysis estimates the amounts of cash you'll need to set aside today to pay the after-tax costs of each alternative, also known as the present value. The option with the lower present value usually is the smartest choice.

A cash flow analysis requires several items of information, including:

- The property's estimated value,
- The purchase and financing terms (including closing costs) or lease terms,
- The estimated useful life of property to be purchased (for depreciation purposes),
- Your costs of capital,
- Your combined federal and state income tax rates, and
- Any incurred costs for leasing or buying (for example, maintenance costs or property taxes).

Your financial advisor can help ensure you consider all of the relevant data.

THE PROS AND CONS OF LEASING

The lower upfront costs of leasing are appealing if your cash flow is precarious (for example, because your firm is still in its infancy). Generally, you need only cover a security deposit of one month's rent and possibly a broker fee. Also, leasing might be the only available option if your firm doesn't yet have the credit rating to secure a mortgage with a reasonable interest rate. For tax purposes, you can deduct rent in the year it's paid.

Leasing leaves you with greater working capital, too, giving you the ability to respond to unexpected opportunities. You're also better positioned to obtain credit than if you were carrying a hefty mortgage.

In addition, commercial leases typically assign the maintenance responsibilities to the landlord, sparing you the time and costs. Leaky roof or piles of snow that need clearing? Not your problem — you can focus on growing your business.

The flexibility is obviously greater with leasing. With proper notice, you can relocate if you require more or less space, want to be closer to a major client or a new courthouse or find more appropriate offices elsewhere.

Leasing may prove particularly wise in areas with uncertain property values. If you have doubts about whether values will rise, you can put the risk of decline or stagnation on the landlord.

Of course, leasing isn't without its downsides. For example, you'll probably be subject to annual rent increases, and your landlord could hike the rent even more when it's time for lease renewal.

LOOK BEFORE YOU LEAP

There's no universal answer to the question of whether to buy or lease your office space. The best choice will turn on your firm's individual circumstances. So take the time to examine them carefully before signing on any dotted lines. •

It's time to pay

REVENUE- VS. PROFIT-BASED COMPENSATION

Today's partner compensation typically goes beyond the traditional lockstep pay structure of years past. The question for firms may revolve around whether to compensate based on the revenue or profit each partner generates. But is a revenue-based compensation system effective? To achieve your firm's long-term goals, a profit-based system may be a better option.

WHY NOT REVENUE?

Focusing on revenues can present a distorted picture of a partner's contributions. For example, Partner John generates $700,000 in billable revenues, performing all the work himself, while Partner Jill generates only $550,000 in revenues at the same hourly rate but also supervises four associates who each bill 2,050 hours. Jill clearly brings more profits to the firm, even though she personally generates less revenue. However, in this scenario, a revenue-based compensation scheme would reward John more.

In addition, focusing on revenues fails to account for the impact of overhead and collections. The partner who generates staggering billable hours but incurs a significant chunk of overhead may be less profitable in the end than one who bills far fewer hours. And billed hours have no value to the firm if they're not collected — all they've done is increase overhead.

Finally, revenue-based compensation can encourage a partner to focus on billables to the exclusion of other activities that support the firm's strategic goals. If, for example, the firm wants to build from within, partners must spend time training and mentoring associates. But partners might be unwilling to do so if it eats into their billable time and thus their revenues and compensation. If compensation instead recognizes contributions to profitability, partners are more likely to sacrifice their own billables to supervise a team of associates.

HOW CAN YOU INCORPORATE PROFITS?

So you've decided to choose a profitability model for partner pay. Now what? Profit-based measures generally can be incorporated into the most common compensation systems. For example:

Formulas. A firm's compensation plan may distribute net profits based on a simple or weighted formula. A simple formula might account for originating work and producing work on a 1-1 ratio, while a weighted formula assigns increased weight to the most important elements, ideally according to the firm's strategic goals. Firms with these types of formulas can increase the weight for elements associated with profitability.

Lockstep. To incorporate profitability under the lockstep approach, require partners to first satisfy specific profit-based metrics, rather than advancing them to the next level based on the number of years they've been partner.

Percentages or units of participation. Many firms pay partners a share of the net profits by assigning each a percentage or units of participation. (The primary difference is that the total percentages must equal 100, while the total units of participation can exceed 100.) Consider more than just ownership interests, seniority and billables when assigning a percentage or units of participation to each partner. Profit-based metrics can play a role in the assignment by taking into account factors like consequential nonbillable time, accounts receivable aging, and write-offs or write-downs.

Reserve systems. Some firms use percentage or units of participation plans that include a reserve portion of net profit (usually 5% to 10%), based on the firm's performance that year. Such firms can take a profits-based approach by allocating the reserve based on work in progress, new business from new and existing clients, and realizations vs. collections.

BUT WAIT, THERE'S MORE

While profits may seem like the most important factor to many law firms, don't forget that the management, administration and planning of and for your firm is what keeps the lights on. Don't forget to include these contributions when deciding on your firm's compensation plan. •

Beyond checks: Alternative methods of payment gaining ground

Paper checks are on the road to becoming obsolete in today's digital-dominated world. For both personal and professional matters, consumers are more likely to turn to other methods of payment, including credit cards and various payment apps. Although law firms have long relied on checks, in part for reasons related to ethics rules, it may be time to consider the alternatives that clients will probably eventually demand.

THE CREDIT CARD OPTION

When is the last time you chose to write a check to pay a bill? Credit card payments — whether in-person or online — are much more common these days, and your clients likely would welcome the same ease when paying their legal fees.

Credit card payments offer additional advantages over checks. With their immediate processing, as opposed to the days of delay that often plague check payments, credit cards can improve a firm's cash flow. They also preclude the risk of lost or bounced payments. Further, accepting significant upfront payments via credit card reduces the need for discounting down the road when clients drag their feet on paying invoices.

> *Attorneys have historically declined to accept credit cards, largely out of concerns of violating professional conduct rules.*

Attorneys have historically declined to accept credit cards, though, largely out of concerns of violating professional conduct rules prohibiting the commingling of client funds with attorney funds. Credit card companies usually charge processing fees that could require firms to tap either trust or operating account funds.

But new businesses such as LawPay have emerged to facilitate credit card payments for law firms. These businesses can deposit funds into trust accounts (for nonearned fees such as retainers and advance payments) or operating accounts (for earned fees) as appropriate and debit operating accounts for the processing fees so firms don't have to worry about commingling.

Of course the cost of credit fees is also a consideration. But typically the other advantages of accepting credit card payments will outweigh the small fees.

PAYMENT APP POSSIBILITIES

Many people, particularly Millennials, have taken to using smartphone apps to transfer money to friends and businesses with the touch of just a few buttons. Several options for making these "peer-to-peer payments" are available, and more are likely to arrive soon.

PayPal, which has been facilitating online payments from credit cards or bank accounts since the late 1990s, also owns Venmo, a popular "social payments" app. Consumers use Venmo — through a phone app or Web interface — to request and send payments. Once payment is received, the funds are transferred to the recipient's bank account.

Square also allows money transfers between users. In addition, it provides credit card readers that attach to a smartphone to process credit card payments.

Apple and Google offer so-called digital wallets, too. Apple Pay links to users' credit card or bank accounts and can be used for store and online purchases; it's available only for iPhones. Google Wallet lets both Android and iPhone users who have Google accounts make purchases in stores and on websites that accept Mastercard and to send money to other users.

If these options seem like a bridge too far at this point, you might want to ease into things by accepting digital bank transfers. Most major national banks have apps that provide a direct connection to the institutions, cutting out the middleman and reducing the privacy and security risks that come with every type of online transaction.

Those risks aren't the only potential drawbacks to consider. Many of the apps have low transfer limits, as well as limits on the amounts being transferred by recipients to their bank accounts. And some may impose transaction fees.

BE PREPARED

The days of clients having to mail or drop off checks for your services are waning. Position yourself for the inevitable shift to alternative payment methods by looking for providers that are familiar with the ethical obligations surrounding trust accounts. Read and understand their terms and conditions (including the fees and privacy policies), and review your jurisdiction's rule of ethics concerning this issue. •

Some firms able to shine in a flat market

Overall, the large law firm market is generally experiencing flat to little growth. Yet some firms have been able to notably outperform their peers.

How do they do it? Of course, factors such as location and client base play an important role. But a recent report from Thomson Reuters Legal Executive Institute found that investments in areas such as business development, marketing and technology may make the difference for high-performing firms.

REPORT METHODOLOGY

Using Peer Monitor data from 165 United States–based large law firms, *The 2017 State of the Legal Market Midyear Report* looked at firms with market-leading growth in overall profits, revenue per lawyer and profit margin.

> *80% of survey respondents anticipate marketing and business development being a major priority for them during the rest of the year.*

The highest-performing quartile of firms increased their marketing and business development expenses by an average of 4.6% last year and grew their per-lawyer technology investment by 3.2%. In comparison, the lowest-performing quartile increased their marketing and business development expenses by only 1.8% and their tech spending by 1.2%.

A STRATEGIC FOCUS

Top performers aren't the only ones that are looking to improve their brands. The report found that 80% of survey respondents anticipate

marketing and business development being a major priority for them during the rest of the year — indicating that more firms are looking to adopt a mindset similar to that of the highest-performing firms.

The report noted that overall market demand growth was only slightly positive for the first six months of 2017, with billable hours rising only 0.1%. Law firms have traditionally driven much of their growth through rate increases. However, that may be an increasingly risky strategy. Even though there has been some strengthening in rates, realizations continue to be at near-record low levels.

Firms last year collected an average of only 82.5 cents for every dollar of their standard rates. According to Peer Monitor data, average write-downs of worked rates increased from 7.8% in Q2 2016 to 8.4% in Q2 2017, as clients continue to push for discounts and write-downs.

PUSHBACK EFFECT

The report noted that perceptions around rate pressures may be somewhat of a self-fulfilling prophecy. Firms are concerned that clients will push back harder on rates — and there's evidence indicating that they will. But in response, the report adds, "partners are showing a willingness to reduce their fees by an increasing margin for the sake of minimizing the chance of the client being upset upon seeing the bill." •

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