



Low-cost lines of credit for case expenses

The cash flow nightmare is beginning to ease by allowing attorneys to pass the costs of borrowing litigation expenses to the client

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At any given moment, trial lawyers have thousands of after-tax dollars tied up in litigation costs. To make matters worse, the IRS has ruled a lawyer is not allowed to deduct case-related expenses in the year incurred because they are considered non-deductible loans to clients. The result: A cash-flow nightmare.

Even if these lawyers are eventually repaid, they take a loss, having forfeited the opportunity to put that money to other, more productive uses in the interim.

Contingency-fee attorneys have been neglected by the finance industry and forced to fund litigation expenses internally or borrow against personal assets.

A partial solution

All firms, big or small, float these expenses which can be a considerable burden. But a solution is emerging. Over the past decade a growing number of states have permitted an attorney passing the costs of borrowing litigation expenses to the client. States explicitly allowing this arrangement include Utah, Florida, Georgia, Illinois, Kentucky, Missouri, New Jersey, New York, Arizona, Ohio, Tennessee and Texas. Permission is implied in many more states, like California, but no formal ruling has been issued. Local rules should be checked.

The ABA Contingent Fee Engagement Letter has been modified for pass-

Firm's pre-tax profits \$2,000,000
Taxes payable on profits@50% (\$1,000,000)
Cash flow after taxes \$1,000,000
Litigation expenses (\$1,000,000)
Net for partners or firm expansion: Zero

Figure A

through of interest expense. It states, in part: "You acknowledge and agree that we may borrow funds from time to time to pay certain of the costs referred to above and agree that, in addition to reimbursing us for the amount of such costs, you also will reimburse us for any interest charges and related expenses we incur in connection with such borrowings."

IRS and non-deductibility of case expenses

The IRS considers case expenses as non-deductible, interest-free loans to the client. This "locked up" capital is not available for growing the practice. Consequently, it is the firm's after-tax dollars

used for funding case costs. A profitable law firm may easily have its revenues taxed near 50 percent (federal, state and local combined). Therefore, the firm must earn \$2 pretax to be able to spend \$1 for case expenses. In Figure A, the law firm must generate at least \$2 million to fund \$1 million in litigation expenses. No money is left to invest in firm growth or to distribute to partners.

Remaining issue

All litigation expenses must be identified from the moment they're advanced and interest calculated separately for each litigation expense by case – a highly impractical and time-consuming proposition for the typical trial firm.

When a Louisiana trial lawyer tried to avoid that Herculean number-crunching by simply using a cost-averaged estimate, the state's Supreme Court slapped him down, holding the loan itself all right, but disallowing any accounting shortcuts. (See *Chittenden v. State Farm* (La. May 15, 2001) No.2000-C-0414, 2001 WL 508342, at *6.)

Banks don't help

Banks don't understand a contingency fee practice. They understand bricks and mortar as collateral. So, unless a lawyer can offer the security of significant physical property – real estate, automobiles – litigation-cost loans may be beyond his or her reach. Plus, banks do not provide required accounting services.



Complete business solution

Specialty finance companies provide innovative financial solutions for contingency fee law firms and their clients that banks won't provide and the necessary accounting services. They understand the cash needs of contingency fee attorneys as a result of the up and down nature of a trial practice, providing firms with the ability to get litigation costs interest free, and removing cash-flow stress.

It works like this: The specialty finance company advances litigation expenses as simply a source for capital. The principal is due at the resolution of each case and interest is due monthly. If struc-

tured properly, the interest is passed on to the case, costing the firm nothing. The rate is based on the current prime rate and there is no interference with the attorney-client relationship.

A word of caution

Do your homework. Choose a company wisely. The terms of a cost-financing transaction vary greatly from company to company, so it may be in the seller's best interest not to base their decision on price alone. Consider the experience and reputation of the company with whom you intend to do business. Get references from reputable sources and talk to attorneys with whom the company has conducted business.



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