Financial management in a contingent fee practice

By borrowing to pay case costs, a firm can use its own funds for other expenses and investments.

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Financing is the bane of most contingency fee practices. An active plaintiffs' firm will have hundreds of thousands, or even millions of dollars, locked up in case costs at any given time. The outlays for litigation expenses do not even qualify for tax deduction[1], since the IRS considers them as non-deductible loans to the client. This "locked up" capital is not available for growing the practice or distributing to the partners.

Many plaintiffs' firms must ration capital. They must turn away good cases because they need all of their existing capital to adequately fund existing cases, let alone finance new cases, mass torts, class actions.

Fortunately, contingency fee law firms now have financing techniques to bring new capital to the firm. Partner equity need no longer be the sole or even the major source of cash for funding litigation costs, practice expansion or smoothing out cash flow cycles.

Traditional self-funding

Most contingency fee firms fund their case costs directly out of firm revenues. This traditional strategy resulted from the irregular, uncertain and long-term patterns to a contingency firm's cash flow. Given the need for highly specialized industry knowledge and the expertise needed to assess the value of a plaintiff firm's "case inventory," most banks are unwilling to lend against a contingency fee practice. If made, bank loans are generally made to a firm's partners, individually, with established loan limits and limited to the personal assets of the partners.

Self-funding is not an optimal financial strategy. Self-funding ties up a large portion of a firm's revenues and a partner's capital in litigation costs. It leaves the firm exposed to a financial "squeeze" in the event that cases-in-process do not pay off on schedule or as forecasted. Furthermore, litigation costs paid directly out of firm earnings result in non-deductible, interest free loans to clients made with the firm's after-tax dollars.

It is the firm's marginal revenues that are used for the funding case costs. A profitable law firm may easily have its marginal revenues taxed near 50 percent (federal, state, local taxes combined). Therefore, the firm must earn $2 pre-tax to be able to spend $1 after-tax for case costs.

Scenario 1: Traditional self-funding

Use earnings to fund the practice
In scenario one, the law firm must have cash flow after all operating expenses of at least $2 million (two times the amount needed to fund litigation costs) to provide the firm with after-tax dollars to fund $1 million in litigation costs. No money is available for the firm to invest in growth or to distribute to partners. *(See Figure A.)*

Using borrowed money to fund case costs

Leverage is the concept of using borrowed money to generate a return. Borrowing to invest in your firm adds to the profitability and value of your firm, provided you can use the borrowed funds for activities to generate new business, to finance litigation costs of a larger caseload, or for investments in

FIGURE A

Firm pre-tax profits	$2,000,000
Taxes payable on profits @50%	(1,000,000)
Cash flow after taxes	1,000,000
Litigation costs	(1,000,000)
Net available for firm expansion, partner draws	-0-

technology, training or human resources necessary to be a more efficient, effective and profitable law firm.

If a firm were to borrow funds to pay case costs, the interest paid to the lender can be deducted as ordinary business expenses in the year paid.[2] With a 50 percent marginal tax rate, the deduction for interest paid reduces in half the after-tax cost of financing the debt capital. Using debt effectively can dramatically enhance the returns on partner's capital and can assist the partners to build both their practice and personal wealth.

Hypothetical firm

Funding case costs with borrowed money can put more capital in the hands of the firm or its partners. *(See Figure B.)*

FIGURE B

Assumptions:

Litigation Costs	$1,000,000 invested in rolling case costs over a two-year period.
Marginal Tax Rate	50%
Interest Rate	14% per annum
Holding Period	Two years required to achieve case outcomes

The loan:

Net Funds Borrowed (Net of loan closing fee)		$1,000,000
Less: Interest on Loan Over Two-Year Holding Period	(280,000)	
Value of Tax Shield (Firm earns a tax deduction on interest)	140,000	
Net Cost of loan*		(140,000)
Net Funds Available for Expansion/Capital Draws		860,000

*Assumes case costs are recouped from settlements/judgments

Scenario 2: Debt funding (leverage) to fund the practice

In Scenario two, the firm borrows an incremental $1 million to be used for ordinary business expenses to grow the firm. The interest is deductible as an ordinary business expense. *(See Figure B.)*

In Scenario two, using leverage (borrowing $1 million for a two-year period) frees up a net increase of $860,000 in capital for the firm to use to grow its business. If the new capital generates enough to repay the principal and interest, or achieves a reasonable return of fees to litigation costs, then this strategy will grow the value of the firm and/or enable partners to increase their annual draws.

Scenario 3: A zero-percent line of credit for case costs

A number of jurisdictions permit an attorney to borrow money to fund case costs and then to pass on a reasonable portion of the interest expense to the client as an additional cost.[3] If the lawyer's fee agreement contains appropriate language,[4] if the interest charged is not usurious and if the client gives an informed consent, then such allocation of interest expense may be permissible.[5]

If the firm were to pass all or a portion of the expense of borrowed capital used for litigation costs on to the client, like it does with other reimbursable expenses of litigation, such as filing fees, experts, or discovery expenses, then the net law firm benefits of borrowing are increased further. Many law firms already charge their clients interest on advanced litigation costs.

Pass-through of a cost of capital– eliminating the practice of granting clients a zero interest loan – further reduces the firm's cost of external debt financing: The first step in reducing the cost of external debt was provided through the value of the tax shield (Scenario Two); a second step may then be available with the recoupment from the client of all or a part of the cost of capital to support their litigation (Scenario three - see Figure C).

In this example, the law firm takes a $1 million loan to grow its business, use for case costs, marketing expenses or to distribute to partners. The per annum after-tax cost to the firm for this financing is only $40,000 versus the $280,000 nominal cost of interest. The clients pay for a share of the interest incurred for borrowing the funds necessary to finance their cases, and the interest expense becomes a deductible expense to the firm. Assuming the case is resolved successfully, passing part of the interest expense for client costs on to clients generates an additional $100,000 for the law firm.

If the new capital can generate a return of at least $40,000 in additional cash flow, then this strategy will grow the value of the firm and enable partners to earn more. Note: If the case is lost, however, the plaintiff is not liable to pay the pass-through interest. Therefore, a firm considering a leverage strategy will need to adjust its use of leverage to incorporate its historical rate in recovering money for its clients.

Summary – Benefits to leverage

This article illustrates how borrowing funds and converting non-deductible litigation expenses (zero-interest loans to clients) into tax deductible expenses, has the cumulative

FIGURE C

Net Funds Borrowed (Net of loan closing fee)		$1,000,000
Less: Interest on Borrowed Funds Interest on Debt ($140,000 x 2 years)	(280,000)	
Interest Income Recouped from Client Recoupment (Assumed interest rate of 10% over 2 years)	200,000	
Net Interest Payable by Firm	(80,000)	
Value of the Tax Shield Firm earns a Tax Deduction on Interest Paid (50%)	40,000	
Net Cost to Firm (assuming costs recouped)		($40,000)
Net Funds Available to fund expansion or partner draws		$960,000

dual benefits of: creating a larger pool of funds for law firm investment in litigation costs, growth and partner distributions, and reducing the firm's net cost of using borrowed funds.

From a bottom-line point perspective, obtaining a loan, whether you pass on an appropriate portion of the cost of money to the client or not, may be a wise financial move for the firm. It provides the law firm with capital needed to grow, to develop cases or to distribute to the partners.

Specialized expertise

Most banks lack the skills and experience to understand the contingency fee law firm. Without the expertise to evaluate and monitor their case collateral and the ability of the firm to originate and settle cases, banks are often unwilling to extend sufficient credit to a contingency fee law firm. A specialty finance company focused exclusively on this form of legal practice will be capable of lending greater sums of capital and on terms that are flexible enough to meet the needs of an individual practice.

A word of caution

Banks are regulated. Some specialty finance companies are licensed but some are not. Do your homework. Choose a company wisely. The terms of various lenders vary greatly so it may be in your firm's best interest not to base your decision on price alone. The profit from using leverage in a successful practice may cover your cost of funds many times over. Select the most reputable, experienced specialty finance firm with whom to develop a long-term relationship and to conduct business.

Conclusion

With all the alternatives available, a contingency fee law firm should carefully weigh the advantages and disadvantages of self-funding against the potential bottom-line gains achievable by adding borrowed funds to increase a firm's capital resources. Using leverage may enable the contingency fee law firm to achieve greater financial rewards for its partners.

Endnotes:

[1] IRS Rev Procedure 97-27

[2] IRC 162

[3] See ethics rules in local state

[4] See ABA Contingence Fee Engagement Letter as modified for pass through of interest expense that 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."

[5] See ethics rules, State Bar Association

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