FEATURE

The Challenge of Financing Contingency Fee-Based Legal Practices

by Stephen Pauwels

Contingency fee-based law firms are capital-intensive businesses which face unique challenges in sourcing the financing required to operate efficiently. This article explores some of the causes and implications of this situation from a practice management perspective and evaluates various alternatives available to law firms facing financing constraints.

Rare is the contingency fee-based legal practice with access to more bank credit than it needs. This is primarily due to these firms' inability to satisfy two of the banks' key lending criteria: cash flow stability and collateral security.

With respect to the first requirement, even the most active contingency fee-based legal practice must contend with significant unpredictability in their cash flows. Under such arrangements, lawyers routinely wait years to realize the fees for their professional services. In the interim, they are obligated to invest thousands, and regularly tens of thousands of dollars on their own account in order to effectively advance each client's claim. From a potential lender's perspective, this cash flow profile bears a greater similarity to a heavy manufacturing business than a professional services firm.

Regarding the second criterion, contingency firms possess little in the way of tangible assets which can be pledged as collateral for bank financing. Moreover, with no contractual guarantee that a firm's outstanding disbursements will be repaid, banks and other asset-based lenders cannot view these as true 'accounts receivable', which they might otherwise take as security for a loan. Even were they to liberally view them as such, banks typically fully discount any accounts receivable over 90 days old – well below the average age of most contingency firms' disbursements. With their highly standardized loan assessment methodologies, banks will similarly attribute no value to the inherent legal fees on active files, which are essentially the most valuable asset of any contingency firm.

Given these factors, it is not surprising that in the absence of personal guarantees and pledges from their partners, contingency firms are routinely denied even the most conservative levels of traditional bank funding that other businesses depend upon to operate efficiently. Exacerbating this financing disadvantage is the fact that unlike virtually all other businesses, law firms are precluded from raising funds through the issuance of common shares. This is due to Canadian Law Societies' restrictions on lawyers sharing fees with non-lawyers.

As an investment banker who has advised hundreds of businesses across a wide spectrum of industries on their optimal balance sheet structures, in no instance have I encountered a business model with such onerous investment requirements yet so constrained in its financing alternatives.

So how do most contingency fee-based law firms accommodate their investment financing needs?

Most rely heavily on their internally generated cash flows – legal fees from resolved files which are redeployed into new and active files in a continuous cycle. Reinvesting earnings back into a business – a form of "equity" financing – is always a prudent and healthy funding practice. Creditors get comfort from the fact that theirs isn't the only capital at risk, and all banks require some minimum level of equity investment relative to the amount they will lend a business. Equity financing also acts as a cushion against swings in the cash flow and hence debt servicing capabilities of a business, enabling owners to conserve necessary funds in lean times that might otherwise be obligated to creditors. This is particularly relevant for contingency firms given the "lumpiness" and seasonal swings in their cash flows.

Contrary to the initial impression of many lawyers we work with, equity financing is not without cost. In fact, despite the fact that these funds bear no direct financing charge or interest rate *per se*, generally speaking reinvested earnings are for any business the most expensive form of financing available. To understand why, one must recognize that these are in essence the profits which a law firm's partners could otherwise be taking home or earning a return from elsewhere. This is an "opportunity cost" which while quite real, unlike interest charges on debt, cannot be deducted from taxable income to reduce taxes payable. Therefore, on an after-tax basis (the only true basis to compare financing costs), equity financing is often considerably more expensive than external borrowing.

Regardless of their cost, internally generated funds have and will always be for most contingency firms the primary source of financing available. Unfortunately, these funds often remain insufficient to accommodate the investment needs of a firm's active files. This dilemma is particularly acute for growing practices, and lawyers in this situation often find themselves "paper rich but cash poor" - showing healthy profits in their financial statements but unable to afford to draw these funds from the practice.

Supplier financing is another common source of funding for contingency law firms. These are the medical experts and other litigation support service providers who agree to wait for payment for their services, often years, until an underlying claim is resolved. Significant supplier financing levels (i.e. greater than bank debt) are a classic symptom of capital constrained businesses stretching for financing sources. This practice - a form of "off balance sheet financing", is generally unsustainable in the long run as it simply shifts the financing burden from the law firm to its suppliers, who eventually run into their own financing strains if they can't effectively offset these costs through mark ups in the cost of their services. Of greater concern is the thought that lawyers would be compelled to select their experts based on their credit policies over their credentials.

While a less accepted practice in Ontario than in Canada's western provinces, some contingency firms get the clients themselves to bear the external costs of developing their claims. While this approach alleviates much of the financial burden from the firm, it does have significant drawbacks. From a marketing perspective, law firms who require their clients to fund disbursements are disadvantaged relative to those who assume these costs themselves. Secondly, a point also raised by Corina Anghel Bachmann in her article on third party litigation financing in *The Litigator* Spring 2008 edition, law firms who transfer the financial risk of pursuing a claim to their clients debatably lose some justification for charging a contingency fee for their services in the first place. Finally, contingency firms are entitled to a unique tax deferral benefit by the Canada Revenue Agency wherein their disbursements can be deducted against taxable income in the period the expense is incurred, not when the underlying claim is resolved. Law firms who shift the disbursement funding burden to their clients, even by simply having their clients co-sign a litigation loan, would lose this tax deferral benefit.

Few would argue the fact that the costs involved in pursuing personal injury legal claims are escalating. Increasingly specialized expert opinions are raising the standard by which lawyers must prove their clients' claims against defendants boasting an arsenal of virtually unlimited financial resources. The unfortunate law firm that routinely exhausts all of its internal and external financing sources is invariably forced to under-invest in its files. Whether this involves deferring or declining to obtain important expert opinions, obtaining assessments from less qualified sources offering more flexible payment terms, or settling files prematurely in order to fund newer cases, this is a deeply troubling scenario for both the law firm and its clients.

And so the question remains - what other alternatives are available to law firms dealing with such financing constraints?

A priority for any law firm regardless of its financial situation should be to regularly examine its existing banking facilities to determine that no better arrangement is available. Too many commercial banking clients are price takers, not realizing that more favourable terms – increased credit, lower financing costs or both can be negotiated with often little effort. On several occasions we have encountered law firms with the same credit line established with their bank 3 or 5 years prior despite the fact that their revenues and profits, along with their funding needs, had doubled or tripled in the interim. Banks will not simply volunteer more favourable credit terms for their clients, particularly in the current credit market environment, but they can be remarkably responsive in this regard if they perceive a risk that their client may move to a competitor. At a minimum, any commercial borrower should revisit its banking facilities on an annual basis.

Once satisfied with its traditional banking arrangements, or its "senior debt", law firms can investigate the suitability of "subordinate debt" sources available within their market. Also known as "bridge" or "mezzanine" financing given their positioning between bank debt and equity on the balance sheet, these are lenders who rank after the banks in terms of their security priority, and as a result charge higher rates of interest (typically 16% - 22% on an annualized basis).

To address a common misconception, bridge financing is not the refuge of borrowers who can't qualify for more traditional bank financing, or the commercial equivalent of what "sub-prime" loans are for the retail housing mortgage market. In fact, most Fortune 500 companies utilize bridge financing to varying degrees as a more flexible supplement to their bank debt, not as an alternative.

Compared with the banks, bridge lenders can offer greater flexibility to borrowers in the amount of credit they are willing to lend, the forms of security they will take and/or their loan repayment terms. These loans can be short term in nature – utilized effectively as an overdraft when bank lines are fully drawn, or form a more permanent part of the balance sheet as a term loan depending on the needs of the borrower.

As bridge lenders are usually industry specific, they often have a greater understanding of their borrower's business and can tailor their financial offerings accordingly. In the case of contingency firms, this means the ability to finance disbursements which the banks have discounted entirely and/or structuring debt servicing payments to coincide with file settlement activity. For example, a contingency firm may use an individual bridge loan to fund inordinately large disbursements on a particular file – electing to defer any interest or principal payments on the loan until the file is resolved should it prefer to do so. Likewise, a more comprehensive bridge credit facility could be established wherein the firm can draw down a series of distinct loans associated with specific files – with repayments coinciding with the settlement activity of each as opposed to the monthly debt servicing banks would require, thereby perfectly matching the firms' cash inflows and outflows.

Importantly, as bridge loans are fully subordinate to a borrower's pre-existing bank financing, they do not affect the general security assignment which would likely have been imposed on the firm by its bank. Likewise, as the bridge loan is a credit obligation of the law firm only, with no claim against any future settlement proceeds of the firm's clients (and therefore not requiring any clients' acknowledgement of the loan), contingency firms retain the ability to fully deduct the accrued interest on the bridge loan for tax purposes as well as the disbursement expenses being financed through it.

Law firms with ample untapped bank credit available on terms they are comfortable with would clearly not need to pay the higher interest rates associated with a bridge loan. Firms not in such a position can determine the economic viability of bridge financing through a cost/benefit analysis. As a simplified example, assume a contingency firm borrows $5,000 through an individual bridge loan bearing interest at a rate of 18.0% per annum, in order to finance an important expert assessment on a particular file which it then successfully resolves one year later. The *Solicitor's Act* enables the firm to recover interest from the client in an amount "not to exceed the bank rate of interest", which has averaged between 3.0% and 4.0% over the past five years. Accrued interest on this loan for one year net of the client recovery (of 3.0%) would therefore be 15.0%, or $750. The firm can deduct this interest against its taxable income, and assuming a tax rate of 40.0%, these tax savings represent $300. As a result, the true after tax annual cost of the bridge loan to the firm is $450, or 9.0%. This doesn't factor in the temporary tax shelter associated with $5,000 disbursement expense itself, which would be deducted from taxable income in the period the disbursement was incurred, and then recaptured as revenue once the case settles (assuming its recovery as an assessable disbursement). It then remains for the firm to decide whether it believes that the incremental return to the law firm on its $5,000 investment in the expert assessment will exceed this "hurtle rate".

Determining the optimal financing mix for any business is as much an art as a science, dependent upon numerous factors both industry and borrower-specific. Contingency fee-based legal practices clearly face greater financing challenges than most other businesses given their significant investment requirements, their lengthy cash flow cycle, and the banks' inability to recognize the true value of their work-in-progress. With traditional financing sources able to offer only a part of the financing solution for most contingency firms, it is important for these businesses to determine what other financing tools are at their disposal beyond their partners' capital, and to understand the pros, cons and true after-tax costs of each before determining how best to achieve the firms' optimal operating efficiency and financial return potential.

***Stephen Pauwels** is a Principal with BridgePoint Financial Services Inc. in Toronto, Ontario.*