

# Why It Works

There's a lot of buzz these days about Brook Hollow Financial and Brook Hollow Capital.

by Brian Michaels

There's a lot of buzz these days about Brook Hollow Financial and Brook Hollow Capital. We guess that happens when you shake-up a dormant market place that only offered plaintiff attorneys tepid solutions to areas of major need. (Taxes and Cash Flow) We feel that it's necessary to address some common themes that keep popping up and give you a little background as well. The most relevant issues are: **1) How do the two programs work? 2) Why do they work? 3) Why is the Assignment Company located in Ireland?**

Those three questions can't be answered without telling you a little about who Brook Hollow Financial and Brook Hollow Capital are and what they do. One quick note that you need to understand before we get into everything is that even though their names are quite similar, they are actually two separate and distinct companies with different ownership structures and different purposes.

Brook Hollow Financial is a consulting firm that works with plaintiff attorneys and plaintiff law firms by analyzing and optimizing how contingent fee income is received. How those fees are realized can literally impact the bottom line of a lawyer or law firm to the tune of millions of dollars over time. This is a serious undertaking, with the real world impact of establishing a solid financial course for the lawyer and/or firm for years to come.

Brook Hollow Financial created the original, and often copied, contingent fee deferral with market based returns, Brook Hollow Financial has been offering this service for over 5 years now and has facilitated a little over \$100,000,000 in deferral in the last 18 months!

In order to help our clients, we work with firms to understand how the firm is organized and how it operates from a business, legal, tax and capital standpoint. We pinpoint the firm's pain-points and specifically identify what the firm wants to accomplish related to its financial future. We then take a look at the firm or lawyers "financials", specifically analyzing current debt and its impact. The primary goals are typically 1) create a solid financial foundation for the law firm, 2) minimize – legally – the net amount paid in taxes on legal fee income received, 3) maximize firm cash flow.

The most basic solution we offer, to assist with the above analysis, is contingent fee deferral. That's really nothing new or earth shattering as far as a plaintiff practice is concerned. These deferrals have been around for years, approved by the U.S. Tax Court in *Childs v. Commissioner* (2103 T.C. 634, 94 TNT 223-15 (1994)), and affirmed by the 11th Circuit U.S. Federal Appeals Court in *Childs v. Commissioner*, (aff'd without opinion) 89 F.3d 856, Doc 96-19540, 96 TNT 133-7 (11th Cir. 1996)). More detail to follow....

## Fall Issue

### Review\_O2

It didn't take long to figure out that many firms were interested in deferring fees but couldn't afford to defer because they needed every penny **NOW**. Many of these had existing, high interest rate loans outstanding and needed the fees to pay off those loans. Other firms loved the idea of the deferral, but needed to preserve access to the fee income to fund their practice

Brook Hollow Capital was created to meet these needs. Brook Hollow Capital is a specialty lender that serves the plaintiff law firm market through the use of innovative and sound lending products. It provides loans to law firms of up to 97% of deferred fees. Brook Hollow Capital also provides Line's of Credit to firms that have deferred fees. You'll learn more about the how and why below.

#### The Due Diligence of our deferral

We're often asked what type of due diligence and research did Brook Hollow Financial perform when developing our program. First off, we did not create the deferral product. It was created by a life insurance company back in the 1980's and subsequently copied by a number of life insurance companies. Of course, it survived the compliance and tax review that those companies are so well known for, and has been through a challenge by the IRS at both the Tax Court and the 11th Circuit (as discussed below). The IRS lost both times. Brook Hollow merely enhanced these existing offerings by basing the payments on market based investments versus fixed annuities or variable indexes. A more technical explanation can be read below, but it is worth noting here that in Private Letter Ruling 199942001 the IRS ruled that a **deferral using variable payments was allowed**.

As many of you are aware, Brook Hollow engaged multiple outside tax counsels, including one of the "Big 4" CPA firms, to assist in the development and review of our new enhanced deferral offering. Space doesn't allow for us to go into a great deal of detail in this article, but we were assured over and over again that the way we structured our program, it soundly met the parameters necessary for income deferral. That is, it complies with the standards set in the Childs case. Words like "Should", and "Strong Arguments" were used to frequently describe our program.

We have completed over 150 transactions in the last 18 months and each firm involved has done some level of its own due diligence. In addition, our program has been positively vetted (opinion letters, memo's, etc.) by a number of outside tax counsel for some of the most prominent plaintiff firms in the country. There are many "Should" opinions floating around.

One last thing about outside due diligence. As you may already know, we are partnered with 5 of the biggest money managers in the world. Each of those firms have vetted our program to various degrees through their tax and compliance departments before agreeing to work with us. That is no small feat given the dynamics of cross-border taxation compliance and reporting required by these multi-national investment firms in a post 2008 world.

#### How and why does this process work? Time to get Technical

When the case generating the fee is settled, the settlement agreement provides that the attorney or law firm will be paid in periodic payments over a set schedule of time. The agreement further provides that the future payment obligation will be assigned to Kenmare Assignment Company Limited (discussed later), with Kenmare making all the future payments. The payments are based upon the returns generated by a market based investment portfolio, which is managed by an internationally prominent, professional money management firm (one of our 5 partners). The payments can also be based upon private equity, private debt issues, and structured notes. **This is an important point.**

Important Note: Often a Qualified Settlement Fund (QSF) is utilized in the settlement process. A QSF is a fund authorized under the Internal Revenue Code (Section 468B and the regulations thereunder) and created by Order of a Court. It is a tax "way-station" and is an effective tool in the settlement process. Procedurally a QSF is:

- Created by order of a Court,
- An Administrator is appointed in the Order
- The settlement proceeds paid by the defendant in the settlement between the plaintiff and defendant is paid into the QSF and
- Then the attorney fee deferral is created out of the QSF. The primary benefits of using the QSF in the fee deferral context are that 1) it gives the attorney and Brook Hollow Financial time to create the optimal deferral, 2) it allows for the settlement to proceed in a timely manner, and 3) it takes the attorney fee deferral out of the eyes and control of the defendant; after all it is none of the defendant's concern what the attorney does with his or her fee income.

The deferred fee process is simple and straight forward:

- Plaintiff and Defendant agree on settlement; when a QSF is utilized it is created at this point and the settlement proceeds are paid into the QSF – claimant funds can be immediately paid out of the QSF
- Plaintiff Attorney meets with Brook Hollow Financial to determine amount to defer and timing of future income distribution
- Execute Settlement Agreement and Release (this is called a Fund Agreement when a QSF is used), which includes an investment policy statement (IPS). The IPS defines the investment plan upon which future payments are based
- Defendant (QSF Administrator when a QSF is used) assigns obligation to make future payments to Kenmare Assignment Company
- Defendant (or QSF when a QSF is used) transfers cash to Kenmare Assignment Company
- Kenmare Assignment Company uses cash to purchase investments to fund future payments
- Kenmare Assignment Company makes future periodic payments to Plaintiff Attorney

#### **What are the income tax rules that allow for this type of structure?**

A lawyer can defer receipt of (and federal income tax on) contingent fees until those fees are received, and have those deferred fees invested, earning pre-tax dollars. These deferrals have been around for years, approved by the U.S. Tax Court in *Childs v. Commissioner* (2103 T.C. 634, 94 TNT 223-15 (1994)), and affirmed by the 11th Circuit U.S. Federal Appeals Court in *Childs v. Commissioner, (aff'd without opinion)* 89 F.3d 856, Doc 96-19540, 96 TNT 133-7 (11th Cir. 1996)). Childs held (the Tax Court holding) that where an attorney defers a contingent fee in a manner such as has been described in this memo, such deferral does not result in constructive receipt of such funds at the time the fee is deferred nor is the deferral current taxable income under the economic benefit rule codified in Internal Revenue Code Section 83.

It is important to note that although constructive receipt is discussed in the following section, the IRS did not appeal that portion of the Tax Court holding. They effectively conceded that a deferral completed according to the Childs methodology is not constructive receipt of the fee. In fact, the IRS has cited Childs a number of times to illustrate the concept of constructive receipt. The only portion of the Childs holding that the IRS appealed was the Internal Revenue Code Section 83 holding, which they lost on appeal, which will be discussed below.

#### **What is the constructive receipt doctrine and how does it apply to deferred attorney fees?**

A cash basis taxpayer is in constructive receipt of income, as opposed to actual receipt, when income although not actually reduced to a taxpayer's possession "is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given." Section 1.451-2(a) of the Regulations. The phrase "or otherwise made available" was added to the Regulation to make it

## Fall Issue

### Review\_O4

clear that a taxpayer's right to draw on income during the taxable year, even if it is not formally set apart or credited, causes income to be constructively received. Rev. Rul. 66-45, 1966-1 C.B. 95. A taxpayer will not have current income under the constructive receipt doctrine merely because he seeks deferral of payments as part of a negotiated settlement. See Reed v. Commissioner, 723 F.2d 138 (1st Cir. 1983). If, however, the taxpayer has a current right to receive all of the funds before a referral mechanism is established, current income cannot be avoided. Williams v. United States, 219 F.2d 523 (5th Cir. 1955).

The doctrine of constructive receipt does not apply in a properly constructed attorney fee deferral, because the attorney has no right to receive the payments before the time fixed by the settlement agreement.

Additionally, it is of utmost importance that the attorney NOT have ongoing control over the investments upon which the future payments are based. Let's be clear here: those investments are the property of Kenmare (or the applicable assignment company) and any direction over or direct control of those investments subsequent to entering into the deferral could likely result in disallowance of the deferral (in tax law, control often effectively equals ownership, which with a deferral is bad). Caution: be suspect of any deferral scheme which allows control or direction over the assets owned by the assignment company during the deferral period. Best practice: build flexibility into the ongoing investment management process at the creation of the deferral, which is the safe and sound Kenmare process.

#### **What is the economic benefit doctrine/IRC Section 83 and how do they apply to deferred attorney fees?**

Under the "economic benefit doctrine," a taxpayer on the cash method of accounting may be treated as having received income in a year prior to actual or constructive receipt in certain limited circumstances. See, e.g., Sproull v. Commissioner, 16 T.C. 244, 247 (1951), *aff'd. per curiam*, 194 F.2d 541 (6th Cir. 1952). A cash-basis taxpayer is taxed currently on the value of the economic benefit conferred when the taxpayer is assured the benefit of future payments, even though such payments will not be made or made available to the taxpayer until subsequent taxable years. A taxpayer is treated as receiving the current economic benefit of future payments when a payor unconditionally and irrevocably establishes a separate fund or trust of assets exclusively for the taxpayer's benefit. Sproull, 16 T.C. at 248 *supra*.

Internal Revenue Code § 83 codified the economic benefit doctrine in the context of compensation for services. In the deferral attorney fee arrangement, the Attorney's fee is compensation for the Attorney's

services. According to Internal Revenue Code § 83, if property is transferred to any person in connection with the performance of services, the person who performed the services is required to include in income the fair market value of such property (less any amounts that were paid for such property) in the first taxable year in which the property becomes transferable or not subject to a substantial risk of forfeiture, whichever comes first. Treasury Regulations Section 1.83-3 (e), provides that "the term 'property' includes real and personal property other than money or an unfunded and unsecured promise to pay money or property in the future." Property also includes a beneficial interest in assets which are transferred or otherwise "set aside from the claims of creditors of the transferor, for example, in a trust or escrow account." Treas. Reg. § 1.83-3(e).

Under Internal Revenue Code § 83, property is taxed, for Federal income tax purposes, when it is transferred to the service provider, unless it is both nontransferable and it is subject to a substantial risk of forfeiture. The taxable event occurs in the first taxable year in which the property either becomes transferable or is no longer subject to a substantial risk of forfeiture. IRC § 83(a); Treas. Reg. § 1.83-3(a). Property is considered transferable only if the rights in the property in the hands of the transferee are not subject to a "substantial risk of forfeiture." This means, if the right to full enjoyment of the property is conditioned upon the future performance of substantial services, a "substantial risk of forfeiture" will be deemed to have occurred. IRC § 83(c) (1); Treas. Reg. § 1.83-3(d).

The statute and regulations do not define when a promise to pay is "funded." See, however, Sproull v. Commissioner, 16 T.C. 244 (1951), *aff'd* 194 F.2d 541 (6th Cir. 1952); Centre v. Commissioner, 55 T.C. 16 (1970); Minor v. United States, 772 F.2d 1472 (9th Cir. 1985). These cases, taken together, concluded that funding occurs when the obligor of the trust is not required to do anything for the trust (or the insurance proceeds) in order for there to be a distribution of the proceeds to the beneficiary. When the beneficiary realizes a non-forfeitable economic financial benefit in the trust (or the insurance policy) the payments become "funded," or secured. On the other hand, when the trust (or the insurance proceeds) is subject to the general creditors of the obligor, funding has not occurred. Childs v. Commissioner, *supra*.

The doctrine of economic benefit and IRC Section 83 do not apply in a properly constructed attorney fee deferral because the assignment to Kenmare contemplates no setting apart of assets, the attorney has no right to assign, pledge or alienate his or her right to receive periodic payments, nor to accelerate or defer any payment there under, and the payments have not become funded as held by both the U. S. Tax Court and the 11th Circuit U.S. Federal Appeals Court in Childs v. Commissioner.

### Why can the deferred fee be invested in any type of asset(s)?

The investment that Kenmare uses to fund the future payment obligation(s) is irrelevant for tax purposes. Kenmare can choose to fund its obligation in any manner whatsoever. Kenmare is contractually bound to pay the future payments based upon the parameters set out in the investment policy statement, which is contained in the settlement agreement.

This is an important concept. The Childs case turned upon the promise to make the future payments, not the funding vehicle used to fund those payments. The promise itself to make the periodic payments was the tax issue decided favorably for the taxpayers in Childs. The deferred fee framework must be constructed according to the Childs framework from a timing and process standpoint. Assuming the process and framework complies with Childs, then the funding vehicle (if one exists at all) is irrelevant for tax purposes.

This is the key to why an attorney may take advantage of the Brook Hollow Capital loan program by combining a deferred fee with a loan. The future payments to be received from the deferred fee structure can be based upon the performance of any asset or managed group of assets as discussed above, including the performance of a debt obligation from Brook Hollow Capital to Kenmare, an equity interest in or debt obligation of a hedge fund type entity, or even a direct obligation from Kenmare. It is of utmost importance when contemplating this type of deferred fee structure combined with a loan that the provision for such is included in the investment policy statement that is a part of the settlement agreement, discussed further below.

### Loan Program - How and why does this work?

A loan is a separate legal and economic transaction. Brook Hollow Capital is not owned by the attorney (nor is Kenmare). Brook Hollow Capital is not owned by Kenmare and Kenmare is not owned by Brook Hollow Capital. Those two companies have different ownership structures. Likewise, the deferring attorney has no ownership in any of these entities, including any hedge fund type entities that may be a party to a Kenmare deferral transaction or Brook Hollow Capital equity or debt funding transaction.

Brook Hollow Capital is in the business of making loans to attorneys. Those loans are priced according to market

conditions, i.e., cost of capital and security of the loans. The attorney must qualify for a loan under the objective loan qualifications established by Brook Hollow Capital. Loan underwriting is an established process, just as with any lender evaluating such a loan.

Brook Hollow Capital may secure debt and/or equity funding from various sources, including equity investors and other independent fund entities, and depending upon the source, is able to loan funds at whatever rate is applicable based upon a number of factors.

Brook Hollow Capital's primary market is plaintiff firms, and even more specific, plaintiff firms that have deferred contingent attorney fees. Brook Hollow Financial understands the plaintiff attorney marketplace and undertakes a tremendous amount of due diligence on the firms operating in that space, including reputation and financial strength, prior to submitting a potential transaction to Brook Hollow Capital for loan approval consideration. This is very important, and one of the factors that separates Brook Hollow Capital from Banks.

A law firm that defers a contingent fee may not pledge, borrow against or factor a deferred fee or it generally becomes taxable at that point. However, it (the deferred fee) **CAN** be a source of loan repayment to be considered when the loan decision is made.

This is a key point for a specialty lender in this space like Brook-Hollow Capital. I won't go into the types of factors lenders look at, or whether and how loans are based upon future income sources (and the likelihood of that income or whether a loan is asset based), but Brook Hollow Capital does know that an attorney who has deferred a contingent fee will be receiving a certain amount on a fixed date(s) in the future and the loan decision can be (at least partially) based upon the likelihood of the deferring law firm receiving those payments. Huge factor.

These loans are no different than separate transactions where an attorney defers a fee and then secures a loan from a bank down the street. For instance, assume the attorney defers a fee with MetLife. Attorney then goes to hometown bank and secures a loan where a consideration for granting the loan is the future payments to be received from the MetLife structured fee. The fee is not pledged; it is merely a source of repayment. It is also similar to borrowing from your 401(k).

### Question 3: Why Ireland?

Brook Hollow Financial is a consulting firm that has a contractual relationship with Kenmare Assignment Company Limited (Kenmare). Through that contractual relationship, Brook Hollow Financial markets the products and services of Kenmare in the United States.



Kenmare is an Irish limited company incorporated, based and subject to the laws of Ireland. It is taxed under the laws of Ireland and operates subject to the U.S. - Irish Tax Treaty. Kenmare is a single purpose entity that accepts, for consideration, the future payment obligations under certain attorney fee deferral, claimant settlement and commercial type transactions.

Centralis International Corporate Services performs all daily operations of Kenmare. They are located in Dublin, Ireland. Centralis Group is a leading provider of outsourced corporate services to an international client portfolio. Founded in 2006, Centralis is headquartered in Luxembourg with offices in Hungary, Switzerland, Ireland, Romania the Netherlands and the United States.

Centralis employs over 70 highly experienced and qualified professionals across all those jurisdictions and have diverse backgrounds, centering on financial, investment and legal professionals with an exemplary client services track records. This is quite different than many of the Caribbean operations of our competitors.

In addition to a highly educated and English speaking workforce, Ireland has a strong legal system based on Common Law. Moreover, Ireland is highly regulated and financially transparent, unlike the Caribbean. Strict Irish government regulations require an annual independent third party audit of Kenmare.

Kenmare is audited by Grant Thornton, the 6th largest CPA firm in the world. This audit confirms and ensures that Kenmare has the assets required to meet its future payment obligations to the attorney/payees, i.e., the assets 1) exist and 2) are invested in a manner consistent with the investment policy statements of each attorney fee, so that the contractually obligated payments to attorney/payees can and will be made.

Also, as part of the audit process, Grant Thornton obtains an understanding of Kenmare's control environment, and accounting and internal control systems. They then assess the suitability of those systems as a basis for their reliance on their adequacy and effectiveness and perform tests to confirm.

Lastly, Grant Thornton plans its audit of Kenmare on the basis of its understanding of Kenmare and consequential business activity, and its business risks. Grant Thornton provides assessments of areas identified where material errors would be most likely to occur.

This third-party audit, required under Irish law, is something that Kenmare is extremely proud of. Its most recently published audit, 2013, shows a clean bill of health, as stated by Grant Thornton. Kenmare is 100% transparent. Can our "Caribbean" competitors say the same thing?

### Irish Accounting Principles

Ireland's tax system, in conjunction with the Ireland – U.S Tax Treaty, allows for U.S. income tax deferral to be effective. This is important because it 1) allows attorney fee deferral under U.S. tax law while 2) providing assurance of the future payments due to the safety of the protections offered and required by the Irish government.

Specifically, Ireland has an accrual based tax system. That means income is matched with expenses for tax purposes. That is important because in the cash based U.S. system, income is taxed when you get the cash, and expenses are deductible when you pay the cash. This is the main reason that assignment companies are located outside of the U.S., and why Kenmare is located Ireland.

All of this financial transparency and accountability cannot be stressed enough.

### Summary

Brook Hollow Financial and Brook Hollow Capital's programs have been repeatedly "put through the ringer" from plaintiff attorneys, law firms, tax attorneys, CPA's, CPA firms, money managers and more. The list is long and the level of attention to detail and the use of intellectual capital are deep.

As I said earlier, this is serious business with serious consequences - positive consequences. Brook Hollow Financial, Brook Hollow Capital and Kenmare provide highly customized analyses and solutions to the plaintiff law firm market that are unmatched.

While these analyses are often complex and the results significant, we constantly strive to streamline and simplify the process to the extent legally possible. The bottom line is that it works, and when used the proper way, is extremely beneficial to our clients. ■



Brian Michaels is  
General Counsel for  
Brook Hollow Financial  
and Brook Hollow Capital.  
He can be reached at:  
bsm@brook-hollow.com