The Evolution of Law Practice Financing

Self-Financing vs. Bank Financing

by Joe Pupel

Historically, law firms self-financed firm expenses, used outside financing, or employed a combination of both. Many firms don't have a "financial strategy," but rather "financial inertia": that is, it's the way the firm has always done business. However, the financial demands on a law practice are changing. It is more expensive to handle a case and the time between cash outlays and recoveries are longer than ever. Additionally, since 2008, access to traditional credit has been all but shut off. The result is that law firm financing has become a competitive factor on par with case acquisition and the practice of law itself. Reliable access to adequate funding, that's reasonably priced, is either a competitive advantage or a competitive disadvantage.

Why borrow in the first place? First, if the return on an investment is adequate to invest your own money; it makes sense to borrow cash for that investment if the costs are reasonable. (After all, the only reason to borrow or invest is if your return will exceed the cost.)

But, if 2008 taught us anything, it's that with debt comes responsibility. Debt has been referred to as "medicine" – it can cure you, but it can also kill you. Finding the right "medicine" can be an art – the right combination of drugs can do wonders, but too much of one can lead to a very dangerous situation. This analogy is very accurate for borrowing. The right combination of debt financing can enhance a practice, but too much could lead to burdensome interest expenses and renewal stress. And don't forget that every borrower is different – medicine can have different effects on each patient. A good way to illustrate the various uses of debt is to study firms that are very good at what they do...but their financial management is at a competitive disadvantage.

Typical Successful Firms

- **The Unprepared Growth Firm:** This firm has been successful and has opportunities. It has just brought in significant fees that it would like to invest in new cases, but those fees are committed to taxes, past and present. And the mismatch between the taxability of his fees and the non-deductibility of investment in new cases seems an unfair limit to its opportunity.

- **The Confident Entrepreneur:** Plaintiff firms are in the business of taking calculated risks. The more confident the firm, the more acceptable the risk. Sometimes, those risks are funded through borrowing. When a firm enters into a borrowing relation ship with a non-traditional finance company, sometimes they get into a vicious cycle and can not exit. We have seen many firms that started with a small line of credit to get them through a lean period, only to see that line grow and become more expensive as their reliance on the lending partner increases. This is one of those firms.

- **The Case Cost Handcuffs:** Oftentimes, a firm's financing is a challenge because capital is tied up in accumulated case costs, a non-deductible expense. Eventually those case costs will be reimbursed, but they can't be deducted along the way and they are an extremely inefficient, but necessary, use of capital. We've met with firms that have case cost expenses in the millions at any given time as a result of their mass tort pipelines. Firms in this situation can either borrow to raise the money for future case costs, or limit their investment in new cases.

- **The Senior Partner Dilemma:** Each partnership agreement is unique – but It seems the senior partners, more often than not, bear inordinate financial responsibility for the firm; a fancy way of saying they write the checks that make sure the bills are paid between settlements. This is especially true in firms where existing lines of credits are already maxed out and cash is needed temporarily while the firm waits on settlement.

- **The M(Ad) Man:** For firms that advertise, they know that every extra dollar they can invest in their advertising budget can mean more cases and more revenue. The problem usually arises because firms do not have extra cash to put towards advertising – every dollar is either tied up in case costs or has been paid out to partners. Imagine if the firm could access capital cheaply to fund advertising.

Whether you are self-financed, a perpetual borrower, or handcuffed by a giant investment in case costs – the solutions available through Brook Hollow Capital can change the way you do business. **Brook Hollow Capital will challenge the way you think about deferral and borrowing and revolutionize the way you use capital in your firm.**

Examples

The Unprepared Growth Firm: This Firm is receiving a $5 million fee on April 1st. The Firm has some immediate cash needs – a $1 million tax bill to be paid from previous year income and a decision about investing in the latest mass tort which has already been evaluated and deemed an excellent investment. The Unprepared Growth Firm could take receipt of the fee and pay the taxes leaving them with $2.75 million in cash. It can pay the $1 million tax bill and have $1.75 million available for the new case. They find this aggravating and would prefer to push the tax bill off into the future, but it needs some cash today if it wants to participate in the new mass tort litigation.

Brook Hollow Capital has a solution. The Firm could defer the entire $5 million with Brook Hollow Capital and borrow 97% (*net of 3% upfront transaction fee) or $4.85 million – meaning there is $1 million to pay the tax bill and a total of $3.85 million to invest in the next mass tort. (That is $2.10 million more than its original option.)

The Firm has turned financing into a competitive advantage and are now able to enjoy the benefits of adequate and inexpensive financing in the acquisition of cases.

The Confident Entrepreneur: This Firm is heavily invested in mass torts. The firm uses a line of credit to help finance the business, and as new opportunities arise, they borrow more. This form of financing can be extremely expensive, oftentimes in excess of 18% per annum. As soon as fees are received, the finance company demands they be used to pay down the line. Only if the finance company shares the Firm's confidence will they continue to lend money. It is easy to see that this can lead to a seemingly never ending cycle – like a hamster in a wheel – always running after the next case, drawing on the line, paying down the line, drawing on the line, etc. One problem with this model is that the finance company exerts too much control and extracts too much gain from the confident entrepreneur...this type of borrowing is not cheap.

If the Firm replaces the finance company with a Brook Hollow Capital loan, it essentially is turning itself into the bank. Every time the Firm settles a case it has new fee income that could be deferred with a Brook Hollow loan as a future capital source. Replacing $10 million in financing at 18% with a loan from Brook Hollow Capital (typically 3-3.5%) can save up to $1.5 million per year in interest! Over 5 years, that's $7.5 million in savings, on financing alone. The Brook Hollow solution provides access to capital, low costs, and much more control over availability.

The Case Cost Handcuffs: Consider a Firm that over 5 years, has sunk case costs of approximately $5 million – over time that firm has had to make $10 million (assuming 50% tax rate) to fund that $5 million in sunk costs. This Firm's partners have deferred the use of $10 million in fees, in the non-traditional sense, but only have the use of $5 million. If you are already deferring $10 million dollars, wouldn't it make more sense to use the full $10 million pre-tax to fund your cases costs?

The Firm could defer the next $5 million fee and borrow $4.85 million* to "unlock" those case costs by distributing cash to the partners. And when the case costs are recovered, those tax-free funds can be used to pay back the loan and then distribution from the deferral. This match of the timing of the fee taxability with the case cost recovery results in a tax situation that seems much more fair to the attorneys.

The Senior Partner Dilemma: Consider a large firm with 20 partners; 4 of which are senior partners. When cases are settled, the fees come into the Firm and are distributed to the partners. Most of the partners want their money today and are not interested in deferral – some because they don't trust the Firm to pay them later. The "check-writing" partners however, would like to use more of the fee revenue to fund the business; which limits the current payout to the partners. Can both groups be satisfied?

Borrowing with Brook Hollow Capital could actually make everyone happy in this scenario. Assume a $10 million fee is deferred and then the firm borrows $9.7 million (*net of 3% upfront transaction fee). Distributions can still be made to the partners that do not want to defer, but the check writing partners can elect to use the borrowed capital to fund the business. When the loan is due, the check-writing partners will receive the original fee they deferred and will have had access to all the funds for the life of the loan, with the added benefit of satisfying their junior partners. This strategy provides reliable access to cheap capital.

The M(Ad) Man:

This scenario is fairly straightforward: the more money spent on advertising the greater the return to the firm. So, a firm's ability to leverage its own resources is huge. A fee income deferral with a subsequent Brook Hollow Capital loan provides not only access to cash that other alternatives do not provde (up to 50% more), it also does it in a low cost (3-3.5%) and tax efficient manner.

Flexible Solutions – Provided by Brook Hollow Capital

As you can see, borrowing can be just what the doctor ordered. Used in the right way – it can turn a competitive disadvantage into a competitive advantage. It can provide access to capital that is cheap and is not subject to the whims of present-day lenders. No one can tell you how you should use your loan proceeds – because each firm has different opportunities, needs, and responsibilities. What should be clear is that the Brook Hollow Capital solutions are flexible and overcome a variety of potential obstacles for firms. Simply, **Brook Hollow Capital can change the way you do business!** ■

Joe Pupel received his BBA and MBA/Tax degrees from the University of Notre Dame in 1987 and 1990, respectively. Joe began his career with PriceWaterhouse Coopers, and has since worked with numerous successful emerging companies and high net-worth entrepreneurs as a contract CFO and CPA. Joe serves as Chief Financial Officer of Brook Hollow.