

Book Review

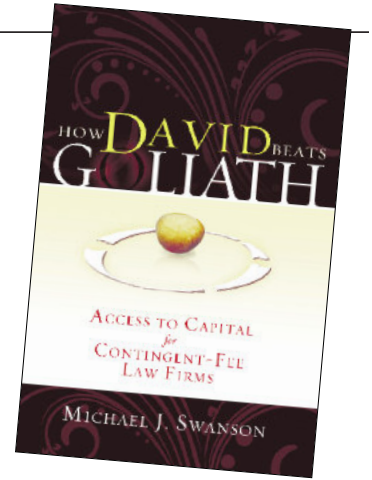
By Jeffrey Isaac Ehrlich
Editor-in-Chief

How David beats Goliath

Access to Capital for Contingent-Fee Law Firms

By **Michael J. Swanson**

Advantage Publishing, 2011, 130 pages



This is a slim paperback but it includes a considerable amount of useful information. If you have run your own contingency-fee practice, you probably know – or at least have thought about – many of the concepts discussed in the book. But the book’s utility does not come from breaking new ground. Rather, it organizes the information presented in a way that helps a firm owner make good choices.

Background

The book is organized into three “Parts” – titled *Background*, *Review of Capital Sources*, and *Application*. There are 17 brief chapters in all. The first part begins with the tale of “Wendy,” a client who suffered a cerebral blood clot that was not properly diagnosed, leaving her with profound brain damage. The point is not the facts of her claim; it’s that her personal-injury lawyer was able to take on her case and pursue it, even though it ended up costing \$295,000 in costs.

The balance of Part 1 explains basic financial terms, like “capital,” “asset,” “opportunity cost” and “time value of money.” It then explains why the financial deck is stacked against contingency-fee firms: they typically have few assets, they can’t sell stock, tying up cash in case expenses represents a high opportunity cost, the IRS claims that case expenses are loans, not expenses; most states prohibit attorneys from charging interest on case expenses; and no outside investors can fund the practice.

Review of capital sources

Part 2 then surveys the various potential sources of funding, and explains the advantages and disadvantages. These include fee-sharing agreements with other firms, contingent lenders, appeal funding, settlement funding, finance



Swanson

company loans, credit cards, partner’s cash, vendor financing, credit lines from banks, and loans with interest pass-throughs. The problem with most of these – particularly contingent lenders, settlement funding, appeal funding, credit cards, and finance companies – is that they are terribly expensive. Anyone who has looked at these sources already knows this.

But the book makes an important and often-overlooked point that fee-sharing agreements with other firms can also be a very expensive way to finance a law practice. Consider the following example: a firm signs up a case worth \$100,000 on a 33 percent retainer, and enters into a deal with a second firm to split the fee 50/50 in exchange for the second firm advancing all costs. The case lasts a year until it settles for \$100,000 and generates costs of \$10,000, which the second firm advances. The firms split the \$29,700 fee equally, with each firm getting \$14,840. In essence, firm one paid \$14,840 for the use of \$10,000 for a year. That means that the fee-split arrangement arguably cost it effective annual interest of 148 percent. This is a sobering example for small firms who routinely agree to joint-venture cases with other firms in exchange for having costs advanced.

Of course, the numbers would be different if the costs were \$30,000. Under that scenario, the effective interest rate drops to 20 percent. These are not complex concepts, but this is an analysis that firms should undertake to evaluate the true cost of fee splitting.

What about just using the partner’s cash to finance the firm and the expenses? Most firms do this, but it’s not without its problems either. Swanson explains

that most contingent-fee firms do not produce high income, and the amount produced varies year-to-year. Hence, if the owner ties up considerable after-tax assets to fund the caseload, this will tend to reduce the owner’s compensation. It also can deprive the owner of the use of funds in a more profitable way; i.e., it creates lost opportunity costs. If you had more cash on hand, you might invest in the Facebook IPO and be RICH!

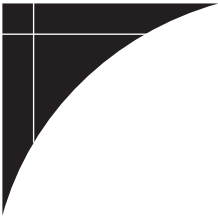
Finally, since most lawyers don’t charge interest on their case expenses (because some states don’t allow it, or simply because it’s difficult to calculate and administer), the result is an underperforming asset. This problem becomes particularly acute because U.S. monetary policy favors growth in the monetary supply over time (i.e., there is likely to be inflation, so money that does not earn interest erodes in value.)

Swanson generally runs through every possible funding source available to the owner of a contingent-fee firm, and shows why it does not work very well for the lawyer over time. Anyone expecting an answer about the “best” approach will be disappointed. There is not one. Rather, Swanson’s goal appears to simply heighten lawyers’ financial awareness and acumen, so they can make better choices.

Application

The third part, “Application” gives advice on how the firm can negotiate a better deal on a credit line, by being aware of hidden costs and traps, like flat fees that apply regardless of whether the line is drawn down. And he warns against blindly relying on trade-association endorsements or preferred vendor programs. He warns that often, an endorsement is sold to the highest bidder, and the association has not necessarily researched the vendor nor

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ascertained if the deal being offered is really better than competing options. Essentially, Swanson explains that lawyers who pay the most attention to their financial situation and who adopt “best practices” in dealing with financial issues are likely to be better able to take advantage of leverage (i.e., borrow more) and will profit by borrowing on better terms and by not tying up their after-tax capital.

The book concludes with some practical tips:

- Minimize net interest costs;
- Don't wait to secure capital until you need it;
- Create a rainy-day fund;
- Pay down the most expensive debt first;
- Monitor liens;
- Know your credit score; and
- Monitor and build your net worth.

As in life, there are no easy answers in Swanson's book. But it's a fast read, and its value is in helping lawyers think about the financial challenges they face, instead of just blindly doing what they have been doing. The book sells for \$14.99 on Amazon. I think that it's worth it.

