

# BROOK HOLLOW

Why It Works





This article answers the four questions I have been asked most frequently over the past twelve years in my role as Brook-Hollow Financial General Counsel, namely: **1) How does it work? 2) Why does it work (and what income tax rules apply)? 3) Why is Ireland involved?** and **4) How does the loan program work?**

Before we get started on answering those questions, it's important to take a look at who we are and how we got started...our background. Brook-Hollow Financial is a consulting firm that works primarily with successful 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 or strengthening a solid financial course for the lawyer and/or law firm for years to come.

In order to do “our thing” and help our clients, we dive into how the firm is structured, how it 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 foundation moving forward. 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 or attorney, 2) minimize – legally – the net amount paid in taxes on legal fee income received, 3) maximize firm or attorney cash flow, while 4) simplifying financial record-keeping and procedures.

The most basic solution we offer is contingent fee deferral. That is 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)).

Time and time again we heard from plaintiff lawyers that deferring contingent fees is a sound and appealing option, but that the investment returns offered by fixed annuities were just plain mismatched to the investment needs of a typical successful plaintiff attorney.

What became clear was that a deferral of attorney fees based upon marketable securities would be an attractive and serious alternative to those traditional annuities.



Brook-Hollow Financial was created to serve this need. We created the original, and often copied contingent fee deferral with market-based returns. Brook-Hollow Financial has been offering this service for more than 12 years now and has facilitated just over \$400,000,000 in deferrals across 350 plus transactions....no small feat.

Another need that we uncovered quickly, especially in the mass tort world, was that many firms were interested in deferring fees but couldn't afford to defer because they needed every penny now. Most had existing, high interest rate loans outstanding and needed the fees to pay off those loans. Sometimes that, in and of itself, created problems because the after-tax net on the contingent fee income wasn't sufficient to pay off the outstanding loan(s), which then necessitated further loans: an unending cycle. Other firms loved the idea of the deferral but needed to preserve access to the fee income.

Brook-Hollow Capital was created to meet these needs. Brook-Hollow Capital is a specialty lender that serves primarily the plaintiff law firm market through the use of innovative and sound lending products. While Brook-Hollow Financial and Brook-Hollow Capital have similar names, they are independent and separate companies with different ownership structures. That is a very important fact from a legal perspective and we can't stress this enough.

### **The Due Diligence of our deferral**

We are often asked what type of due diligence and research Brook-Hollow Financial performed when creating our deferral solutions. First off, we did not create the product. It was created by a life insurance company back in the 1980s and copied by a number of life insurance companies since then. 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 Financial engaged multiple outside tax counsels, including one of the "Big 4" CPA firms, to assist in the development and review our new enhanced deferral offering and were assured that our deferral program more than 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 describe the program.

In addition, we have been told, our program has been positively vetted (opinion letters, memo’s, etc.) by a great number of outside tax counsel for some of the most successful plaintiff firms in the country. There are many “Should” opinions floating around. We have done over 350 transactions and have gone through various levels of due diligence with each of the firms involved.

Also, as part of our program, we are partnered with several of the biggest money managers in the world. We have been vetted by their tax and compliance departments as well. That is no small feat given the dynamics of cross-border taxation compliance and reporting required by these multi-national investment firms.

## HOW DOES IT WORK?

When the case or matter 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 a, professional money management firm. The payments can also be based upon private equity or private debt issues and structured notes. The investment options are extremely broad, and worthy of a separate article all together. If there’s something particular you’d like to invest in (with your pre-tax deferral), just ask!

*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 a solid and effective tool in the settlement process. Procedurally, a QSF created by an Order of a Court, an Administrator is appointed in the Order, the settlement proceeds are paid by the defendant in the settlement between the plaintiff and defendant into the QSF and then the attorney fees 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 process is simple and straight forward.

**1** 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

**2** Plaintiff Attorney meets with Brook Hollow Financial to determine deferral amount, future payment schedule, and investment parameters (with input from financial professionals)

**3** 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

**4** Defendant (QSF Administrator when a QSF is used) assigns obligation to make future payments to Kenmare Assignment Company

**5** Defendant (or QSF when a QSF is used) transfers cash to Kenmare Assignment Company

**6** Kenmare Assignment Company transfers cash to the custodian and investment manager chosen by client (virtually all based in the U.S.)

**7** Kenmare Assignment Company makes future periodic payments to Plaintiff Attorney



## WHY DOES IT WORK (AND WHAT INCOME TAX RULES APPLY)?

A lawyer can defer receipt of (and federal income tax on) contingent fees until those fees are received, and have those deferred fees invested pre-tax. At the basic level, this functions like a typical 401(k), without all the tax restrictions. 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)). The Tax Court in *Childs* held that where an attorney defers a contingent fee in a manner such as is described in this article, 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 in appeal, further 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 Code of Federal Regulations. The phrase "or otherwise made available" was added to the Regulation to make it 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 deferral 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). Caution: be suspect of any deferral offering 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 Kenmare's process.

### **What is the economic benefit doctrine/IRC Section 83 and how does it 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(s) that Kenmare uses to fund the future payment obligation(s) is irrelevant for tax purposes. Kenmare can choose to fund (or not fund, for that matter) its obligation in any manner whatsoever. Kenmare agrees to pay the future payments based upon the parameters set out in the



investment policy statement, which is contained in the deferral 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 structure must be constructed according to the *Childs* structure from a timing and process standpoint. Assuming the process and structure 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 structure 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, when combined with a loan, that the provision for these types of investments is included in the investment policy statement that is a part of the deferral agreement.

## WHY IS IRELAND INVOLVED?

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, based in 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 Group is the operations division of Kenmare and 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, United States of America, Ireland, Romania and The Netherlands.



Centralis employs more than 150 highly experienced and qualified professionals with diverse backgrounds, centering on financial, investment and legal professionals with an exemplary client services track record. This is quite different than many of the Caribbean operations of our competitors where you'll literally find a small dusty office, mostly unoccupied, with a nicked up old wooden desk, a lone telephone and a beat-up filing cabinet.

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, one the largest CPA firms 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 deferral, so that the contractually obligated payments to attorney/payees can and will be made.

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, unlike the U.S. tax system which is primarily cash based, whereby 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.

It can't be stressed enough that the main reason Kenmare located itself in Ireland was because of financial transparency and accountability. The Grant Thornton third-party audit that is required under Irish law is something that Kenmare is extremely proud of. Kenmare is 100% transparent because of this and that's something that I doubt our competitors can or will say.

## **HOW DOES THE LOAN PROGRAM WORK?**

Brook-Hollow Capital is a specialty lender. It primarily makes loans to law firms representing plaintiffs and typically earning most of their income from contingency fees. A Brook-Hollow Capital loan is a separate legal and economic transaction. Brook-Hollow Capital is not owned by Kenmare and Kenmare is not owned by Brook-Hollow Capital. Likewise, the deferring attorney has no ownership in any of these



entities, including investment options that may be a party to a Kenmare deferral transaction or Brook-Hollow Capital equity or debt funding transaction.

Brook-Hollow Capital 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 the rate most applicable based upon various 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, while the majority of banks do not. Further, Brook-Hollow Capital performs extraordinary 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.

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. 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.



## SUMMARY

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.

Brook-Hollow Capital and Brook Hollow Financial understand the needs of the marketplace and offers best-in-class solutions.

While these analyses are often complex and the results significant, we strive to streamline and simplify the process to the extent legally possible. You'll never find us recommending case and expense tracking as a part of our solution; because it is unnecessary and unnecessarily burdensome. Likewise, we won't ask you to trust your future income to a non-transparent company based in some Caribbean country that takes three flights, two stop-overs and two days to get to. Sorry, I couldn't resist.



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