Joint Ventures Between Attorneys and Clients

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Mergers and acquisitions issues arise in a wide variety of contexts, often where you least expect them. One particularly interesting question, which raises ethical as well as tax issues, is whether and how a taxpayer can form a joint venture with his attorney for tax purposes. Historically, this discussion has come up because of what seem to be unfair tax rules, which tax plaintiffs on money they don't actually collect.

As you might expect, the root of the issue is contingent legal fees. Some courts have described a contingent fee agreement as a joint venture. In effect, the client brings his or her claim, and the attorney brings time, effort, and legal savvy [*DeGraff v. McKesson & Robbins, Inc.*, 292 NE2d 310 (N.Y. 1972)].

There can be considerable tax dollars at stake, with some contingent fee awards exceeding $100 million. If contingent fees are fully deductible by the plaintiff, how you view the fee contract should hardly matter. But if the plaintiff cannot deduct the fees, or can

only deduct them below the line, the taxes can be painful. A true joint venture might save the plaintiff significant taxes.

In business litigation, of course, there is no need for worry as legal fees are fully deductible as business expenses. But for individuals not operating a business, the question is what type of deduction for the fees applies. In some cases, plaintiffs may fully deduct contingent fees above the line.

That is the rule for virtually any employment case and for many whistleblower cases too. But beyond these exceptions—and thus, for most types of cases—plaintiffs can be hit hard by taxes on money they never see. This is where the joint venture argument comes in.

Nothing Ventured?

If a plaintiff forms a joint venture with his attorney, their partnership may receive the proceeds, but the partners are taxed. The contingent fees can be seen as simply the attorney's proceeds from the venture and taxed accordingly. Some courts initially agreed with this argument [*see A.L. Clarks Est.*, CA-6, 2000-1 USTC ¶50,158, 202 F3d 854, 857–858].

Under this view, the contingency fee is the result of the lawyer and the client dividing their property. It is not the plaintiff *assigning* income to the attorney. However, more than a decade ago, the Supreme Court appeared to close the door on this argument.

In *J.W. Banks II* [SCt, 2005-1 USTC ¶50,155, 543 US 426, 125 SCt 826], the Supreme Court held that contingent fees are normally taxable to the plaintiff, period. The Court noted that an attorney is an agent who can act only in the interests of the client. Thus, the full amount of the recovery must be treated as income to the client.

Still, intriguingly, the Court made it clear this was the "general rule." That must permit exceptions, and the Court even alluded to some possibilities, including some arguments made in the case that the Court did not reach. However, the Court rejected the notion that the taxpayer and the attorney had formed a joint venture or partnership.

But the question remains, could a plaintiff and attorney form a joint venture for tax purposes, perhaps under different facts than the ones presented in *Banks*? Many in the tax community have felt that *Banks* closed the door on this possibility. But it may not have done so. The real problem is not *Banks*, but rather whether the traditional attorney-client relationship can be (re)structured as a joint venture. It is worth considering the implications of *Banks*, both for contingency fee taxation and for joint venture taxation more broadly.

Allum: Hope for Joint Venturers?

One post-*Banks* case suggested that a joint venture between an attorney and client is possible, with the right facts. In *R.L. Allum* [90 TCM 74, Dec. 56,100(M), TC Memo. 2005-177], the Tax Court pointed out that determining whether a partnership exists for federal income tax purposes requires one to examine whether, in light of all the facts, the parties intended to create a partnership in good faith and acting with a business purpose.

Then, the Tax Court applied traditional partnership factors from *W.O. Culbertson, Sr.* [SCt, 49-1 USTC ¶9323, 337 US 733, 742, 69 SCt 1210]. The factors include:

- The agreement,
- The conduct of parties in execution of its provisions,
- The parties' statements,
- Testimony of disinterested persons,
- Relationship of the parties,
- Respective abilities and capital contributions,
- Actual control of income and the purposes for which it is used, and
- Any other facts throwing light on the true intent.

The list of factors is long, to be sure. However, according to *D.G. Haley* [CA-5, 53-1 USTC ¶9350, 203 F2d 815, 818], a joint venture is nothing more than a "special combination of two or more persons, where in some specific venture a profit is jointly sought without any actual partnership or corporate designation." A joint venture arguably does not require sharing of profits *and* losses.

Moreover, Code Sec. 761(a) does not specifically require that a joint venture be formally designated. Under this broad standard, might it be possible for an attorney and a client to form a joint venture? The Tax Court in *Allum* suggested that it is.

In fact, there the Tax Court said that the taxpayer failed to provide any evidence

supporting his claim that a partnership or joint venture existed between him and his attorney. Indeed, the *Allum* case suggests that if there were evidence, the result could be different.

What would need to change? For one, documentation that such an arrangement existed might not hurt. The *Allum* court noted that there was no partnership agreement, and no filing of partnership tax returns. In fact, there was only a bald assertion in a brief that such a *de facto* partnership existed. Documenting the existence of a joint venture could help. But documentation is not the only piece.

Under *Banks*, Control Is Key

In *Banks*, the Court explained that "control" over litigation is what drives the attribution of income from the action for tax purposes. The Court stated that in "the case of a litigation recovery the income-generating asset is the cause of action that derives from the plaintiff's legal injury" [*Banks*, 543 US 435]. As the Court explained, the plaintiff typically retains "dominion over this asset throughout the litigation" in a contingency fee case [*id.*].

Because of this, plaintiffs are taxed on the whole recovery, even their attorney's contingent fee. According to *Banks*, "looking to control over the income-generating asset, then, preserves the principle that income should be taxed to the party who earns the income and enjoys the consequent benefits" [*id.*, at 434–435]. This language is key to the Court's decision and suggests that a joint venture requires more than a mere shared profit motive.

There must be some sharing of control over the venture as well. If a plaintiff and attorney could share some degree of control over the case, the plaintiff might have an argument under *Banks* to avoid taxation on the attorney's contingent fee recovery. The difficulty, though, is precisely what the *Banks* court noted. The client typically retains control and dominion over the income-generating asset throughout the case.

The client decides when to settle, and for what amount. The attorney can conduct the negotiations, but control over major litigation decisions often rests with the client. Because plaintiffs typically retain this exclusive control, it is difficult under *Banks* to argue that they should not be taxed on their attorney's contingent fee.

A client and attorney could nevertheless agree to form a joint venture. That can and should be documented. They might even file partnership returns with respect to the litigation. But without real elements of shared control, the joint venture is unlikely to be respected for tax purposes.

Redesign of Attorney-Client Relationship?

Is there any way to document and structure the contingent fee arrangement to give the attorney some shared control over the litigation? Plainly, a contingent fee attorney has a significant interest in the outcome of the case. The lawyer's recovery depends on the amount of any settlement or trial verdict.

If the attorney and the client shared authority regarding settlement in some respect, could the venture perhaps pass muster under *Banks*? The Supreme Court's language suggests that it might. And there is some support for such a model.

The Fifth Circuit has stated that an attorney has a property interest in a former client's claim when their contingent fee agreement restricts the former client's ability to settle or dismiss the lawsuit [*Keith v. St. George Packing Co.*, CA-5, 806 F2d 525 (1986)]. Arguably, if the attorney shares some control over settlement of the underlying litigation, the contingency fee recovery might be income to the attorney under *Banks*, not the plaintiff.

Legal Ethics

Sharing control over litigation may be helpful for tax purposes. And in many settings, perhaps it reflects a kind of common reality. The lawyer may make strong recommendations, may drive tactics, and may ultimately have something approaching the final say in many cases.

Yet giving legal effect to this kind of *de facto* control may raise serious complications in terms of legal ethics. It could be seen as a conflict of interest, or even a breach of the duties the lawyer has to the client. Indeed, the ABA's Ethical Guidelines for Settlement Negotiations state that "Conditioning agreement to representation on a waiver of the client's right to approve a future settlement, or on the client's agreement not to settle without the lawyer's approval, would fundamentally and impermissibly alter the lawyer-client

relationship and deprive the client of ultimate control of the litigation" [August 2002, Committee Notes to 3.2.3 (*Avoiding Limitations on Client's Ultimate Settlement Authority*)].

The rules in most states are not as clear-cut as the ABA's comments suggest. Yet, it is traditionally understood that the client *alone* has the authority to make settlement decisions. Also, lawyers are traditionally prohibited from entering into business ventures with their clients, which may pose another hurdle.

Because of this, it may make sense to include a savings clause that "notwithstanding anything herein to the contrary, this agreement shall be interpreted as a partnership between lawyer and client only to the extent permitted by law." But this is no guarantee that the lawyer has not stepped over the line.

The more that control is truly shared, the more likely it is for tax authorities to respect the joint venture. However, it is a delicate balance. The tax rules require sharing of control, while the legal ethics rules discourage sharing of control. It is tricky, and the more attorneys encroach in one area (control), the more such ethical issues may be triggered.

The Fired Attorney Model

Are there any solutions that would comport with the legal ethics rules? The agreement in *Keith v. St. George Packing Co.* [CA-5, 806 F2d 525 (1986)] suggests a possible model. That agreement provided that the client could not settle the case unless the attorney was present and received his one-third share.

What is revealing about the *Keith* case is that the attorney was discharged before the case concluded. Thus, it became fairly clear that the attorney had his *own* interest in the contingency fee. The federal appeals court ruled that the attorney had a property interest in the suit and could even intervene to protect it. This is a key fact.

It is possible that *Banks* would have been decided differently under these or similar facts, especially if there had been partnership documentation. Other cases also help support this conclusion [*see Valley Ranch Dev. Co. v. FDIC*, CA-5, 960 F2d 550 (1992) ("A contingency contract thus constitutes an 'interest.'")]. If the attorney has an interest in the lawsuit, and has his *own* seat at the settlement table, the argument for taxing the plaintiff on the contingency fee seems a tougher sell for the government.

In the *Keith case*, both the original attorney and the plaintiff ultimately became parties in the suit. They were both needed to settle the case. This is arguably a form of shared control, which could pass muster under *Banks*. The argument under *Banks* seems to get even better if the defendants require a release from the attorney as part of the overall settlement, and indeed obtain one. This scenario is certainly unusual, but it happens, and it illustrates a broader point.

Whether or not the original attorney is discharged, the *Keith* line of authority suggests that the attorney can have his *own* interest in the contingency fee. He can even litigate to protect it and have a seat at the table at settlement talks. This suggests that the contingency fee agreement between plaintiff and attorney might more clearly lay out what happens in the event that the attorney is discharged.

Once the attorney is discharged and the fiduciary relationship ends, the *Banks* rationale for taxing the plaintiff on the contingency fee is harder to apply. The original attorney now has an independent and identifiable interest in the outcome of the litigation. He can even bring suit to enforce this interest, and the defendants may require him to sign a release before agreeing to release any funds. Especially if the original attorney becomes a separate party in the proceeding or in the settlement negotiations, it is harder to see how the plaintiff should be taxed on the contingency fee.

Joint Venture Implications

But is it a joint venture? In the scenario where the attorney is fired, one could argue that an agency relationship has now *become* a joint venture. Still, the attorney at this point is arguably no longer acting as the client's fiduciary. Even so, it seems odd to label the new situation as a joint venture between the plaintiff and a fired attorney, although maybe this description is correct.

Under *Banks*, arguably all the attorney needs is a separate and independent *interest* in the contingency fee. It needs to be one that the plaintiff does not control (or over which the

plaintiff at least does not have *complete* control). Whether it is a joint venture or not may not be necessary to decide. The key under *Banks* is that whoever controls the income-producing asset (*i.e.*, the litigation) recognizes income from the settlement. If the attorney has some modicum of control over his own income-producing asset (his interest in the suit), it may make less sense to tax the plaintiff on the contingency fee.

Banks is ostensibly a case about taxation of contingency fees. However, *Banks* suggests that in analyzing joint ventures for tax purposes, control is the most important feature. Conceiving of the attorney-client relationship as a joint venture certainly upends the traditional notion of the attorney-client relationship and may not even be needed to solve the problem of contingency fees.

A carefully designed contingency fee agreement, taking into account state ethics rules, seems worth exploring. The *Keith* model is a start, and laying out what would happen in the event the attorney is discharged couldn't hurt. The facts in *Keith* are fairly unusual, and it is not every day that a plaintiff fires his attorney *and* the attorney then has his own seat at settlement talks. But it may not be necessary to actually fire an attorney to make this point.

The original contingency fee agreement might clearly specify the attorney's interest in the event of discharge and even provide for protecting the attorney's interest at settlement. If the parties arranged for the attorney to have a protected interest in the outcome of the litigation, for state law purposes, this could help even more.

Regardless of whether it is ultimately styled as a joint venture, a well-designed agreement might help plaintiffs hoping to avoid taxation on their attorney's contingent fees.

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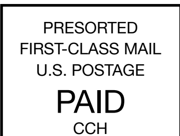

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