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Structuring Attorney Fees When You're Not a Solo

These days, plaintiffs' lawyers are beset by lots of controversy, lots of attention in Washington and, whether or not you view the phrase as a misnomer, lots of "tort reform." Consequently, lawyers are under considerable financial pressures, and have more than the usual uncertainty about their income. Now, more than ever, there are tax, asset protection, and financial reasons why many plaintiffs' lawyers are finding that leveling out what can be an erratic and unpredictable income makes sense.

How do you do this? You may be able to do a bit of leveling by controlling when cases settle, but most lawyers find that pretty difficult to control. A far more certain method by which plaintiffs' attorneys are leveling out their income is by structuring their contingent fees. Fee structures are increasingly being considered as a way to meet a lawyer's income-leveling goals, plus achieve tax savings, establish asset-protection strategies and meet even estate-planning goals. I'm finding attorney fee structures to be dramatically increasing in popularity.

Buying Some Insurance

Plaintiffs' attorney fee structures are facilitated in large part by insurance companies. In lieu of taking agreed-upon contingent fees at the time the case is resolved, an attorney fee structure involves the attorneys agreeing to defer their fees. Fortunately, the attorney need not rely on the plaintiff, or even the defendant to pay the outstanding fees. Instead, the attorney will receive a stream of guaranteed payments from an insurance company. In this manner, plaintiffs' attorneys obtain the benefits of income leveling, asset protection, tax deferral, estate planning, and more.

Attorney fee structures are an outgrowth of the structured settlement industry. Most plaintiffs' lawyers have some experience with plaintiffs taking their recovery over time via annuities. Such structures were originally devised for serious personal injury cases, where the plaintiff got the security and tax advantages of a stream of payments over many years. Today, even in non-personal injury cases, plaintiffs often want to structure part or all of their recovery.

Although structured settlements are still quite popular in personal injury cases, and have morphed into employment litigation and other contexts, plaintiffs themselves aren't the only ones interested in security and tax efficiency. Today, increasingly, it's the lawyer's turn.

Sometimes both lawyer and client structure, sometimes only the client, and sometimes only the lawyer, depending on their respective needs and desires. Insurance companies are generally willing to structure lawyers' fees, even if the plaintiffs don't want to structure their recovery. This willingness creates tremendous flexibility for plaintiffs' attorneys to decide when and how to receive their fees.

Ultimate Flexibility

Fee structures allow a pre-tax accumulation of wealth, so attorneys can defer fees until they need them. Attorneys can convert a contingent fee into payment streams of every shape, size, and flavor imaginable. A structure can provide a stream of income of virtually any duration. Payments can be made over the life of the attorney, can be issued as a joint and survivor annuity with the attorney's spouse, or can call for a plain balloon payment. There is even flexibility in increasing or decreasing payment amounts over time, including having interim lapses in payments or multiple payment streams, covering college costs for children, and so on.

What happens if the client wants to structure, but the attorney does not? Conversely, what happens if the attorney wants to structure, but the client does not? Although the marketplace has answered this question by making structures available in any of these circumstances, the industry has had some concern over fee agreements.

For example, the California Bar announced that where a fee agreement is silent on the question of structuring, an attorney in California cannot collect fees upon the settlement of the case if the plaintiff will receive structured set-

tlement payments.[1] In other words, absent a contrary agreement in the fee contract between the lawyer and client, the lawyer must participate in the structured settlement in order to receive attorney fees.

Of course, this is generally only an academic issue, since plaintiffs often do structure. Moreover, even if the plaintiff doesn't structure, there's virtually no reason the plaintiff would object to the lawyer structuring. In fact, sometimes a plaintiff's tax problems can be significantly lessened when the lawyer structures, since it can reduce the attorney fees the client must deduct in one year.[2] I've seen a few attorney fee structures designed to help the plaintiff's tax situation, though doubtless the lawyer gets an advantage too.

From the Beginning

Structuring attorney fees has been widely accepted for more than 10 years. The lynchpin of such structures is the Tax Court opinion in *Childs v. Commissioner.*[3] In *Childs*, three lawyers practiced law through their professional corporation, Swearingen, Childs & Philips (SCP). In 1984, SCP took on two gas explosion cases. The firm settled both cases, and because they were big recoveries and the lawyers were cautious, they structured their legal fees. Yet, in each case the *firm* didn't receive the stream of payments. Instead, the plaintiffs directed payment to each attorney individually, bypassing SCP completely. Each attorney structured his portion of the contingent attorney fee separately in each settlement.

The SCP firm did not report any of the contingent fees from either settlement. After all, it hadn't actually received any of the payments. All three lawyers reported their annuity payments over time as they received them. The IRS challenged the tax returns of all three attorneys, arguing that each payment stream should be included in the attorneys' income in its entirety in the tax year when the first payment was received. Interestingly enough, as we'll discuss below, the IRS raised no issue about the fact that the money all went to the three individual lawyers, not to their firm.

In any case, the attorneys went to Tax Court, and the Tax Court sided with the attorneys.[4] Ten years ago, the Eleventh Circuit affirmed *Childs*, laying the groundwork for attorneys nationwide to structure their fees. Based on this authority, attorney fee structures have achieved a level of comfort.[5] Yet, in the decade following this seminal decision, a few issues surrounding attorney fee structures are rarely discussed. Perhaps the most interesting issue not expressly decided by *Childs* (and not addressed by any other legal authority since) is the lack of focus on the legal entity through which Childs and his partners practiced law.

The case draws no distinction between who actually received the attorney fees (the three lawyers) and who was legally entitled to the contingent fees (their professional corporation). The sole focus of the case is on timing. The case asks the question of whether the attorneys are taxable on the cash they *could* have received, or only on the annuity payments as they receive them over many years.

Maybe timing is everything. Yet, the clients hired the *firm*, and signed a fee agreement with the firm, not with the attorneys individually. The attorney fees were paid to each attorney individually. When each case settled, each attorney structured his own fees.

Childs Play

The Tax Court details how the three attorneys practiced law. They had a professional corporation, in which Childs and his "partners" were really shareholders. The three lawyers were not acting individually when they settled the underlying tort cases. Each attorney structured his fees *individually*, not as part of the professional corporation in which he was a shareholder. The professional corporation was apparently entitled to receive contingent fees in both settlements, yet neither the IRS nor the Tax Court mentioned it. More surprising, no court since has addressed this seemingly important issue.

Readers might be wondering why I'm making such a fuss over the lawyers' direct receipt of their fees. After all, lawyers are individuals, and the legal work they perform is based on their own legal judgments. Yet, a professional corporation (or other legal entity through which a law firm operates) is hard to ignore when it's entitled to receive contingent fees. The professional corporation provides numerous benefits to its shareholders which make it important. On a general level, a professional corporation provides a certain element of protection for its shareholders (*e.g.*, in tort, contract, bankruptcy, etc.).

Suppose I practice law in a professional corporation. If a delivery person slips and falls on the floor of my office, my personal assets should not be at risk. If the same delivery person wins a judgment against my firm for negligence, forcing my firm into bankruptcy, my personal assets should still be protected. This situation would be quite different if I was practicing through a general partnership, where my liability would extend not only to my interest in the firm, and to all firm assets, but to my personal assets as well.

If that slip-and-fall example seems silly, let's take another example. What if I'm sued for my own malpractice (or for the conduct of personnel whom I supervise)? Here, a professional corporation (or LLP) doesn't help. Yet, if I'm sued for the malpractice of a fellow shareholder (someone whom I colloquially call my "partner"), a professional corporation (or LLP) will shield my own personal assets from the lawsuit. There is a shield for what is usually called "cross-liability."

A professional corporation offers other benefits besides shareholder protection, such as deferred compensation. Some years ago, attorneys, as individuals, could not obtain certain pension benefits. These benefits were limited to professionals employed by corporations. Thus, attorneys often

took to self-incorporating to obtain those benefits. Some attorneys took this action even though they were a partner or an associate in a law firm partnership. That's the reason you still sometimes see law firm letterheads that proclaim the firm is a "partnership including professional corporations." I'm seeing less self-incorporating today, since the pension benefits playing field (as well as the entity choice playing field) has now been more or less equalized.

Choice of Entity

Some of the questions about disregarding the legal entity may be less important when attorneys operate through a pass-through entity, such as a general partnership, a limited liability partnership or an S corporation. There is still a nagging question: What if attorneys structure on an individual basis, but the client has engaged the law firm as a whole? In *Childs*, the fact that payments were made directly to the attorneys as individuals did not bother the Service.

There may be a couple of reasons for this. Perhaps the Service is considering the payments as first made to the law firm, and then deemed paid from the law firm to the individual attorneys. There is a certain amount of common sense to this. These fictional back-to-back payments would help respect the law firm as an entity, and would take into account the fact that the law firm is entitled to its contingent fee.

Of course, such deemed payments are not uncommon. The IRS uses this fiction in many areas. Still, attorneys may be able to prevent the IRS from implementing its own characterization by executing their own deemed payment agreements. Although it may not be an absolute necessity, I believe it is often appropriate for the periodic payments of the structure to be made directly to the attorneys. The law firm could account for the receipt of the payments as if it had actually received them, and then could account for the monetary transfer to the attorney. In effect, it should be a wash.

Beneficiaries

Aside from Mark Twain, most people do not like to discuss the subject of their untimely demise. Attorneys who are structuring fees are no exception. Many of them structure payments to plan for retirement, and the thought of not being around to enjoy their long-awaited retirement is anathema. Still, some thought must be given to survivor's benefits.

Structuring attorney fees usually entails the defendant (or its insurance company) assigning its obligation to make structured payments to an assignment company. Assignment documents frequently have standard beneficiary language such as: "any payments made after the death of the Claimant pursuant to the terms of this agreement will be made to the Estate of the Claimant." In my experience, attorneys like this language (or at least don't often ask to change it), and it remains in many assignments.

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Even though attorneys may not frequently change the language, insurance companies usually do not mind changing the beneficiary. They are willing to accommodate the attorney, since their payment obligation is discharged upon making payment to whomever the attorney may direct. Changes to the standard language sometimes reflect a calculated desire to incorporate post-death payments into an existing estate plan. Attorneys sometimes have payments directed to a spouse or child. Alternatively, payments may be directed into a family trust.

Attorneys can change the standard language relatively easily. Yet, even small changes can complicate tax matters. Given the fact that there is some uncertainty about whether an attorney who is not a solo has the right to payments on an individual basis, one approach is to have the law firm deemed to continue to receive the post-death structured payments. The firm can have an agreement to make payments to the attorney's estate, spouse, family trust, etc.

It is possible that payments from the law firm to the attorney's beneficiary may be considered income in respect of a decedent, or IRD. In essence, IRD is income earned by the services of the decedent before death, but which is collected after death by the estate. IRD is a subject which even tax attorneys tend to avoid.

Perhaps the simplest method to avoid this complication is to liquidate the law firm. Upon liquidation, the right to receive future structured payments would be distributed to the attorney's estate. Of course, liquidating the firm may be appropriate for a small firm. A larger law firm may not be willing to liquidate just to accommodate a single deceased partner. In any event, there can be a huge problem if the law firm is a C (as opposed to S) corporation.

Before leaving this topic, let's consider how the IRS may treat structured attorney fee payments which are paid directly to a family trust, and not to the attorney's estate. As noted above, the law firm may be considered the proper recipient for tax purposes. If so, the law firm can still make a deemed payment to the attorney in the same manner as if the attorney were alive. These payments would presumably go to the attorney's estate.

Of course, this does not solve the question of how the money gets from the attorney's estate to his or her family trust. Perhaps this would be yet

another deemed payment. Perhaps it does not matter, as the IRS has not suggested that it cares about any of these subtleties. After all, *Childs* would have presumably given the IRS plenty of opportunity to complain about the mismatch between the party originally entitled to fees under the fee agreement (the professional corporation) and the parties who were the beneficiaries of the annuities once the fees were structured (the three individual lawyers).

Commutation

Some pundits say the untimely demise of an attorney is an oxymoron. Such quibbling aside, the untimely demise of an attorney who is receiving structured attorney fees can cause liquidity problems for the attorney's estate. Estate tax is due shortly after a taxpayer dies, and 2006 rates reach as high as 46%. Some insurance companies will help estates with this liquidity problem, allowing structured payments to be accelerated upon death. Mechanically, this can be accomplished by inserting a commutation clause into the assignment agreement.

Sensibly, the commutation clause has gained popularity in recent years. A typical commutation clause might provide that all (or a portion) of the present value of the remaining structured payments are payable to the attorney's beneficiary upon the attorney's death. The primary reason attorneys may want an express commutation clause is to ensure that their estate has sufficient resources to pay estate tax.

The good news is that the mere presence of a commutation clause under these circumstances doesn't spell constructive receipt.[6]

Presumably, death removes the acceleration from the recipient's control. Yet, I have not found many defendants who were keen to insert a commutation clause into a settlement agreement, since on its face, it appears contrary to the IRC § 130 no-acceleration requirement. Nevertheless, this is not stopping insurance companies from inserting the clauses into their assignment documents.

An alternative to using a commutation clause to access the cash is to enter into a factoring transaction.[7] Here, the recipient of the structured payments can assign the right to receive all or a portion of the future payments to a factoring company in return for a current lump-sum payment. Factoring should serve the good of averting a liquidity crisis caused by the estate tax, but it adds a layer of administrative complexity and cost.

Notably, the Tax Code provides in general that there is a 40% excise tax on certain factoring transactions of qualified assignments (*i.e.*, § 104 injury cases).[8] The excise tax can be avoided if the parties obtain a qualified court order. The order must find that the transaction is in the best interest of the payee, taking into account the welfare and support of the payee's dependents. Also, the order must not contravene any state or federal law, among other requirements. As a practical matter, these additional requirements now included in the Internal Revenue Code have legitimized the factoring industry.

Conclusion

The structuring of attorney fees has become more and more common. Most major insurance companies are in this line of business, and I rarely meet a plaintiff's attorney who hasn't at least heard of the concept. Yet, there seems to be only the most basic guidance from the IRS. The IRS lost the issue in *Childs*, and can't look back.

Attorney fee structures represent a very attractive payment alternative. There is no adverse case law and there is (in my opinion) no reason to think that will change. Perhaps the IRS's relative silence even may equate to administrative acceptance.

Yet, attorneys who are sole practitioners appear to have relatively less trouble in theory and in practice when it comes to structuring payments. Ask any insurance structured settlement broker. Non-solos can certainly structure too, but some attention to form is a good idea (if not downright necessary). If form has not been respected and the IRS decides to make an issue of the practical aspects of the structuring arrangement, there could be trouble.

Despite my own thoughts on this topic, both the Tax Court and the Eleventh Circuit in *Childs* tacitly approved structuring *without* any concern about respecting the professional corporation. That simple fact suggests this isn't much of a problem. The Service took no interest in this (seemingly big) issue. At least the IRS did not argue about it by the time the case reached the Tax Court and the Eleventh Circuit. The fact that this seems quite literally to be a sleeper issue does make me wonder.

Are these hairs so finely split that the courts and the IRS would not notice or care? Perhaps they are. Based on the *Childs* decision, the identity of the structuring party vs. the party earning the fees – let alone the argument of how post-death payments get to a family trust – may be too academic for taxpayers as well as the IRS. The IRS could revisit this issue, which causes me to want to plan around the potential problem.

Because of this, I favor an income allocation agreement that recognizes the separate status of the professional vehicle. Even without such an agreement, if the IRS does pursue this issue, the *Childs* case is a bulwark against which attorneys can take refuge. ■

1. *See* California Bar Ethical Op. 1994-135.

2. The attorneys fee deductibility point is discussed in Wood, *Supreme Court Attorney Fee Decision Leaves Much Unresolved*, Tax Notes (Feb. 14, 2005) p. 792.

3. 103 T.C. 634 (1994), *aff'd*, 89 F.3d 856 (11th Cir. 1996) (mem.).

4. For more details of the *Childs* decision, see Wood, *Structuring Attorney Fees: Kingdom of Heaven?*, Tax Notes (Aug. 1, 2005) p. 539, 2005 TNT 142-28.

5. *Id.*

6. *See* I.R.S. Priv. Ltr. Rul. 98-12-027 (Dec. 18, 1997).

7. *See* Wood, *Structuring Settlements & Factoring: Never the Twain Shall Meet*, Tax Notes (Mar. 14, 2005) p. 1278.

8. IRC § 5891.