When You Are Not a Solo, Should You be Concerned About Structuring Fees?

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Introduction

These days, plaintiffs' attorneys 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." In this climate, plaintiffs' attorneys may be facing more than the usual uncertainty about their often erratic and unpredictable income. Now more than ever, there are tax, asset protection, and financial reasons why many plaintiffs' attorneys are finding that it makes sense to level their income by spreading out payments.

How do you do this? You may be able to do a bit of leveling by controlling when cases settle, but most attorneys find that difficult to control. A far more certain method is for attorneys to structure their fees, *i.e.*, have their contingent fees structured so that payments are received over time. I am finding that plaintiffs' attorneys, whether solo practitioners or attorneys who practice within a law firm, are more often considering structured fees as a way to obtain their income leveling goals—plus achieve tax savings, establish asset protection strategies, and meet estate planning goals. The seminal case, *Richard A. Childs* (1994) 103 TC 634, aff'd (11 Cir 1996) 89 F3d 856 (unpublished opinion), laid the groundwork for attorneys nationwide to have a level of comfort in structuring their fees. But although solo attorneys who structure their fees can rest easy after *Childs*, plaintiffs' attorneys who practice with a firm may want to sleep with one eye open.

Childs in Play

Perhaps the most interesting issue not expressly addressed by *Childs* (and not addressed in any reported case since) is the attorneys' rights to payments on an individual basis even though their firm was entitled to the contingent fee. In *Childs*, three attorneys who practiced law through their professional corporation, Swearingen, Childs & Philips (SCP), settled two gas explosion cases. Because their recoveries were big, they structured their legal fees in each settlement. Each structured his fees *individually*, not as part of the professional corporation in which each was a shareholder. 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 attorneys reported their annuity payments as they received them. The IRS challenged the attorneys' tax returns, arguing that they had "constructively" received the whole stream of fees at the time of settlement. The Tax Court sided with the attorneys (as did the Eleventh Circuit in affirming the decision), holding that the entire value of the attorneys' rights to receive deferred fees was not gross income in the year of the settlement.

Childs drew no distinction between who actually received the attorneys' fees (the three attorneys) and who was legally entitled to the contingent fees (their professional corporation). The sole focus of the case is timing: whether each attorney was taxable on the cash they *could* have received, or only on the value of each annuity payment as it is received over many years. Maybe timing is everything. Nonetheless, the clients hired the *law firm* in *Childs*, and signed a fee agreement with the firm, not with the attorneys individually.

Why the Fuss?

Readers might be wondering why I am making such a fuss over the attorneys' direct receipt of their fees in *Childs*. After all, attorneys are individuals, and the legal work they perform is based on their own legal judgments. But a professional corporation (or other legal entity through which a law firm operates) is hard to ignore when it is entitled to receive contingent fees. The professional corporation provides numerous benefits to its shareholders.

For instance, for liability purposes a professional corporation provides a certain element of protection for its shareholders (*e.g.*, in tort, contract, and bankruptcy). What if I am sued for my *own* malpractice (or for the conduct of personnel whom I supervise)? A professional corporation (or LLP) doesn't help in this situation. But if I am 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.

A professional corporation offers other benefits besides shareholder protection, including deferred compensation. Some years ago, attorneys, as individuals, could not obtain certain pension benefits. These benefits were limited to professionals employed by corporations and so attorneys often took to self-incorporating to obtain these benefits. Some attorneys took this action as a partner or an associate in a law partnership. That is the reason you still sometimes see law firm letterhead proclaiming that the firm is a "partnership including professional corporations." I am seeing less self-incorporating today because greater access to these benefits has leveled the play-

ing field in pension benefits across the various entities through which one can operate a business.

Attorneys Take Their Turn

The clients of attorneys—plaintiffs—were the first to benefit from deferred payment structures. Attorney fee structures grew out of structured settlements in personal injury cases. Structured settlements enable plaintiffs to obtain the security and tax advantages of receiving periodic payments over time. Most plaintiffs' attorneys have some experience with their clients taking their recoveries this way through the purchase of annuities to fund the future payments. Still popular in personal injury cases, structured settlements have crossed over into other disputes, including employment litigation. Plaintiffs themselves are not the only ones interested in security and tax efficiency. Today, increasingly, it's the attorney's turn.

In the structured fees context, in lieu of taking agreed-on contingent fees at the time the case is resolved, plaintiffs' attorneys agree to defer their fees. Fortunately, the attorney need not rely on the plaintiff, or even on 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, and estate planning.

Depending on their respective needs and desires, sometimes the attorney and client both structure payments. However, insurance companies are generally willing to structure attorney fees, even if the plaintiff does not. The availability of structured payments in the marketplace in many different circumstances has created tremendous flexibility for plaintiffs' attorneys to decide when and how to receive their fees.

Ultimate Flexibility

Structured fees 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, or can be issued as a joint and survivor annuity with the attorney's spouse. The structure can also call for a plain balloon payment. There is even flexibility in increasing or decreasing payment amounts over time, including having interim lapses in payments and/or multiple payment streams, covering college costs for children, for example.

Despite this flexibility, the State Bar of California has raised concerns over structured fees when the client structures, and the attorney does not. For example, when a fee agreement is silent on the question of how fees will be paid in the event of a structured settlement, an attorney in California may receive fees only on the same prorata basis that the client receives compensation. See California State Bar Formal Opinion No. 1994–135. In other words, absent a written agreement between the attorney and client permitting the attorney to receive the entire fee at the time of settlement, the attorney must participate in the structured settlement.

Even in the reverse situation when the plaintiff does not structure, there is virtually no reason the plaintiff would object to the attorney structuring his or her fees. In fact, sometimes a plaintiff's tax problems can be significantly lessened when the attorney structures, because he or she can reduce the attorney fees to be deducted in 1 year. I have seen a few attorney fee structures designed to help the plaintiff's tax situation, though doubtless the attorney gets an advantage, too.

What If?

Structured fees are a great way for plaintiffs' attorneys (both solo and nonsolo) to level their income. Still, *Childs* left on the table nagging questions: If attorneys structure their fees on an individual basis, but the client has engaged the firm as a whole, can the identity of the firm be disregarded? What are the attorneys' rights to the fees? Some of the questions *Childs* left unanswered 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.

In *Childs,* the fact that payments were made directly to the attorneys as individuals did not bother the IRS or the Tax Court. There may be a couple of reasons for this. Perhaps the IRS considered 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.

Such "deemed payments" are not uncommon. The IRS uses this fiction in many areas. Attorneys may be able to take advantage of this type of fiction by executing their own deemed payment agreements with their law firms. 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

With the possible exception of Mark Twain, most people do not like to discuss the subject of their untimely demise. Attorneys who are structuring fees are no exception. Many attorneys structure payments to plan for retirement, and the thought of not being around to enjoy their long-awaited retirement is anathema. Nevertheless, attorneys should give some thought to survivor benefits when structuring their fees. The concern over the identity of the structuring party arises in this context because

beneficiaries add another layer of individuals (or entities) who are receiving fees.

As part of the structured fees transaction, the defendant (or its insurance company) usually assigns its obligation to make structured payments to an assignment company. Assignment documents often 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 do not often ask to change it), and it remains in many assignments.

Nevertheless, attorneys can change the standard language relatively easily to suit their estate planning purposes. Insurance companies usually do not mind changing the beneficiary to accommodate the attorney because their payment obligation is discharged on making payment to whomever the attorney may direct. Changes to the standard language sometimes reflect a calculated desire to incorporate postdeath payments into an existing estate plan. Attorneys sometimes direct payments to a spouse or child. Alternatively, payments may be directed into a family trust.

To avoid lingering uncertainty about their right to payments, nonsolo plaintiffs' attorneys could take the approach that the law firm would continue to receive the postdeath "deemed payments," *i.e.*, the firm can have an agreement to make payments to the attorney's estate, spouse, family trust, or other entity. Unfortunately, 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 viewed as another "deemed payment." Perhaps it does not matter, because 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 (professional corporation) and the parties who were the beneficiaries of the annuities once the fees were structured (individuals).

Acceleration of Payments

Some wags say the untimely demise of an attorney is an oxymoron. Such jibes aside, consider that the untimely demise of an attorney who is receiving structured 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 percent. Some insurance companies will help estates with this liquidity problem, allowing structured payments to be accelerated on death. Mechanically, this can be accomplished by inserting a "commutation" clause into the assignment agreement. 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 on the attorney's death.

The primary reason an attorney may want an express commutation clause is to ensure that his or her estate has sufficient resources to pay estate tax. The good news is that the mere presence of a commutation clause under these circumstances does not spell constructive receipt, as argued by the IRS in *Childs*. See IRS Letter Ruling 9812027. Presumably, death removes the acceleration from the recipient's control under a constructive receipt analysis. I have not found many defendants who were keen to insert a commutation clause into a settlement agreement because, on its face, the clause appears to ring the prohibited acceleration bell.

Insurance companies will, however, insert the clauses into their assignment documents. An alternative to using a commutation clause is to enter into a factoring transaction. 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. The upside of factoring is that it can avert a liquidity crisis caused by estate tax; the downside is that it may add a layer of administrative complexity and cost. For further discussion on factoring, see Wood, *Stucturing Settlements & Factoring: Never the Twain Shall Meet*, Tax Notes, Mar. 15, 2005, p 1278.

Conclusion

Increasingly used by plaintiffs' attorneys, structured fees represent a very attractive payment alternative. Most major insurance companies are in this line of business, and I rarely meet a plaintiff's attorney who has not at least heard of the concept. The rights of nonsolo attorneys to receive individual payments when their firm is due the contingent fee do not appear to be in danger—there is no adverse case law and there is (in my opinion) no reason to think that will change. Perhaps the IRS's silence on the issue is golden.

The identity of the structuring party versus the party earning the fees—let alone the argument of how postdeath payments get to a family trust—in the end may be "splitting hairs" for taxpayers as well as the IRS. Still, the issue seems quite literally to be a sleeper. Because the IRS *could* revisit the issue, I favor an income allocation agreement that recognizes the separate status of the law firm, as I have discussed in this article. Even without such an agreement, if the IRS does take on the issue of the identity of the structuring party, *Childs* provides a solid bulwark against which attorneys can take refuge.