PERSPECTIVE

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Beware consequences of admission in SEC settlements

By Robert W. Wood

These days the Securities and Exchange Commission wants some defendants not merely to pay, but also to admit guilt. Admitting guilt in a civil case? This rubs many defendants the wrong way. Besides, it is an about-face from the SEC's longstanding practice of settling civil litigation *without* requiring the defendant to admit wrongdoing.

Exactly what circumstances will merit this special "I'm guilty and bad" treatment will be determined case-by-case. The SEC says most cases will still settle under the "neither admit nor deny" policy. But requiring admissions of guilt in stand-alone civil cases is a worry.

Apart from public image issues, companies worry that private civil litigation is a certainty after such an admission. Tax deductions for settlement payments may be impacted, too. Tax advisers invariably think about the dichotomy between nondeductible fines or penalties and compensatory or remedial payments.

Defendants may want language in settlement agreements confirming that a payment isn't a penalty and is remedial in nature. Sometimes, the government refuses. In *Fresenius Medical Care Holdings Inc. v. United States*, 2013 U.S. Dist. LEXIS 66234 (D. Mass. 2013), the government made it clear that it *would not and could not* agree to any tax characterization in the settlement agreement itself.

Fresenius, a medical device company, settled with the government and resolved claims for criminal and civil health care fraud. Fresenius paid a criminal fine of $101 million and a civil settlement of $385 million. The company deducted the civil settlement payments, which the Internal Revenue Service later disallowed as nondeductible penalties.

Suing for a tax refund, Fresenius said there was no penalty. After all, this was a civil settlement. Plus, while the settlement agreement may not have had explicit tax language, it did address taxes.

The settlement agreement stated that "Nothing in this Agreement constitutes an agreement by the United States concerning the characterization of the amounts paid hereunder for tax purposes." In fact, the government had required that language when the case settled and monies were paid. Yet when it became a tax dispute, the government said the only way Fresenius could deduct the payment as compensatory would be if the settlement agreement *expressly* allowed it.

Talk about a Catch-22! The government argued that the parties must agree on the purpose of a settlement payment in order to characterize the payment as compensatory for tax purposes. Yet, the government had refused to agree prior to the tax dispute. Sensibly, the court ruled that an advance agreement is *not* necessary. The court also didn't like that the government seemed to think its contradictory behavior was fair.

Of course, whenever the settling parties can agree, they should. Indeed, the *Fresenius* court did say that a characterization agreed upon by the parties or announced by a judicial officer may well be *determinative* for purposes of taxation. As a practical matter, tax language in settlement agreements may not legally bind third parties like the IRS, but it does goes a long way in avoiding disputes.

The *Fresenius* court said that, at a minimum, the parties' negotiations may provide evidence of the appropriate treatment of payments to the government. However, the *Fresenius* court noted that these negotiations and the eventual settlement agreement will seldom be the sole evidence available. The court said it would also look to the non-contractual evidence regarding the purpose and application of the payments.

Interestingly, the court noted that the same terms can have different meanings. Thus, "non-punitive" for purposes of the Double Jeopardy Clause of the U.S. Constitution does not mean "non-punitive" for purposes of the Internal Revenue Code. Moreover, other provisions within the settlement agreement expressly stated that they did not characterize the settlement payments as non-punitive for tax purposes.

No one wants to be involved in a tax dispute. Companies concluding litigation want to pay the money, deduct it, and move on. The government attitude displayed in *Fresenius* should send a chill through the bones of many litigators, many in-house legal officers, and many a tax adviser, too.

If the government refuses to insert explicit tax characterization language in a settlement agreement, and later asserts that the *only* way you could have the payment treated as compensatory is to have had express language, what will you do? Sure, this might be over a long period of time. It probably would also involve different arms of the government, from the Department of Justice to the IRS.

Plainly, one should keep supporting correspondence and documents. Be thoughtful and careful about what they say. Something just short of explicit tax language in the settlement agreement may prove to be very helpful.

Thus, if you cannot get language in a settlement agreement attesting to the compensatory and remedial intent of *all* the payments, consider sacrificing a modest or appropriately reasonable portion. If the number for the penal and punitive portion is not too large, you may be better off conceding that some hopefully small portion is penal and nondeductible in exchange for the relative certainty that you can deduct the rest. Remember, if you insist on all or nothing, sometimes you get nothing.

If you are selecting an amount that will be nondeductible, try to have a theory on how you got there. Be consistent. Explain your theory and your allocation, either in the settlement agreement or in a backup memo.

It never hurts to go overboard in gathering your non-penalty evidence. After all, you may not have seen all the ammunition that will be used against you in a later tax dispute. You have control over what correspondence you send, and you will know what you have received.

However, there will be other items, perhaps internal DOJ communications, correspondence between the DOJ and the IRS, or other inter- and intra-agency materials. Try to gather what you can whenever you can. Consider creating some self-serving documents of your own.

You may want to record impressions, observations, and facts contemporaneously with the settlement. Lawyers and company officials can be appropriate signatories for those items. It is done far less frequently than it should be.

To give them added gravitas (and perhaps even admissibility), think about having them signed under penalties of perjury. Consider all these items early on as you are negotiating the settlement of the case. Documents prepared at tax return time — or even worse, at audit time — are never as persuasive.

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