Can Class Action Attorney Fees Be Structured?

By Robert W. Wood

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Attorney fee structures may be common, but the question whether court awarded attorney fees can be structured is less so. Court awarded fees may be especially large in class actions, and that gives rise to a correspondingly larger interest in legal fee structures. Wood focuses on court awarded fees in class actions and explores whether they can be structured.

Plaintiff attorneys receiving contingent fees are in the enviable position of being able to structure them, something that sounds vaguely like a credit default swap or some other risky financial arrangement. Actually, legal fee structures are hardly exotic, and for almost 20 years have had the imprimatur of the Tax Court. Attorney fee structures are simply a series of payments made over time. They are analogs to the structured settlements the clients of plaintiff lawyers may receive for all or part of their net recovery.

Like structured settlements, structured legal fees do not involve the defendants themselves making periodic payments. Instead, the arrangements presume that the defendants will make a lump sum payment to a third-party annuity provider. The annuity provider, in turn, will make the periodic payments to the lawyer. If the lawyer acts at the right time and documents the fee structure in the appropriate way, he can forestall the receipt of fees that he has in a literal sense ''almost'' fully earned. That qualifier is a key tax constraint and in some ways is quite artificial.

The lawyer may have worked on the case generating the fee for years to get it to the brink of settlement. In that sense, the lawyer may have done 99.9 percent of the work necessary to generate the fee. Nevertheless, assuming that the lawyer complies with the mechanical rules, he can elect to receive the fees in a series of periodic payments made over time. Moreover, that is true for the amount of the fees and for the investment return that will be generated on those fees.

It must be stressed that there are technical nuances to be observed. For plaintiff attorneys in particular, that is important to note. They have been known to call their tax adviser only after they are holding the money in their trust account, wondering if it is then too late to structure (it is). Yet by merely adhering to a few formalities, fee structures provide enormous benefits.

They permit the accumulation of earnings on a pretax basis. They also facilitate the leveling of income in a field that is often characterized by unpredictable peaks and valleys. With the life insurance annuities that are the standard structure vehicle, they also can provide conservative investment return and asset diversification.

Finally, unlike most forms of deferred compensation, attorney fee structures are not subject to section 409A.[1] Since its enactment in 2004, section 409A has dramatically changed the nonqualified deferred compensation landscape. That structured attorney fees are not subject to those restrictions is all the more remarkable.

In general, legal fee structures are accomplished under a contingent fee agreement. The lawyer has a contingent fee agreement entitling him to a 40 percent (or other percentage) fee on any recovery. Yet at nearly the last minute before he has earned his fee, he may elect not to be paid in cash but rather to accept periodic payments.

Usually, the contingent fee agreement allows an election or can be amended to provide for it. However, it is not clear that the legal fee agreement *must* so provide. In fact, many legal fee structures are accomplished under a fee agreement that simply provides for a cash contingent fee. That was

[1]Notice 2005-1, 2005-1 C.B. 274, *Doc 2005-435*, *2005 TNT 4-7*.

true in the seminal Tax Court case *Childs v. Commissioner*,[2] which provides the framework for attorney fee structures.

The Class Fee Conundrum

Although legal fee structures are common today, legal fee structures of court awarded fees are uncommon, particularly those awarded under a class action. In a class action, whether or not there is a fee agreement with class representatives, attorney fees are almost always the subject of a court approval process. In many cases, that court approval process obviates and supersedes any fee agreement.

Can attorney fees awarded by a court in class actions be structured? Based on established concepts of constructive receipt and economic benefit, I believe the answer is a decided yes. Although I will stick to the concept of class action attorney fees in this article, I note that it may be possible to apply the same concepts I will discuss to non-class-action court awarded fees.

The *Childs* Case

Childs v. Commissioner is the mother of all structured attorney fee cases. There, the IRS unsuccessfully challenged a transaction that paid three attorneys their fees on a structured basis. Predictably, the IRS asserted that the attorneys were entitled to all the fees at settlement, so had constructively received the whole stream of fees for tax purposes.

That seemed like a good argument, because the attorneys clearly decided very close to the conclusion of the case to structure their fees over time rather than take them in cash. Yet applying established constructive receipt and economic benefit concepts, the Tax Court rejected the IRS's argument, as did the Eleventh Circuit. Both courts held that the value of the attorneys' rights to receive deferred installment payments of fees was not includable in gross income in the year of the settlement.

The structure considered in *Childs* has come to be the standard for structured legal fees. The lawyers do not want (and will not accept) a promise from the defendant (or even from their own client) to pay their fees in installments. Lawyers want an annuity that provides a guaranteed stream of payments issued by a highly rated life insurance company.

The settlement agreement actually incorporates the language of the legal fee structure. It must be clear that the attorney has no ability to alter the payment stream or accelerate payment. The settlement agreement provides for the purchase of annuities to satisfy the installment payments of the attorney fees, and sets out (in the settlement agreement or an attached exhibit) precisely how and when they will be paid. The settlement agreement also stipulates that the attorneys' rights under the annuity policies are no greater than those of a general creditor. These are generally the same rules that dictate structured payments for plaintiffs.

In *Childs*, each attorney's structure was slightly different, but there were common themes. Before the settlement documents resolving the case were signed, the parties agreed that all the legal fees would be paid in structured payments. In *Childs* and in the typical case, the defendant is willing to pay the entire sum for lawyer and client in cash.

For the lawyer's share, the defendant pays an assignment company to assume the obligation to make the periodic payments to the lawyer. The assignment company is usually a special purpose subsidiary wholly or partially owned by a major U.S. life insurance company. The assignment company then purchases an annuity from its parent insurance company to fund the settlement payments.

The annuity is issued to the assignment company which continues to hold the annuity and remit the periodic payments to the lawyers. The attorneys are each named annuitants under the annuity contracts and their estates are designated as primary beneficiaries. The annuities are subject to the rights of general creditors of the assignment company.

However, the parent life insurance company (which issued the annuities) issues its own guarantee to pay the annuity payments should the assignment company ever fail to pay the attorneys. Therefore, the insurance company is still liable to pay the attorney fees if the assignment company ever fails to pay any installment. The attorneys have no right to accelerate the payments or reduce them to their present value.

Once the attorneys agree to structure their fees, they are bound to the installment schedule. The attorneys agree in the documents that they have no rights against the assignment company greater than those of a general creditor. The Tax Court and the Eleventh Circuit held in *Childs* that on those facts the attorneys did not constructively receive the fees in the year the settlement documents were signed.

Court Awarded Fees

We may think of attorney fees due under a contingent fee agreement and court awarded fees as fundamentally different. In the case of a contingent fee, there has been no event triggering the lawyer's right to income until the settlement agreement releasing legal claims has been fully executed or until a judgment has been entered. The former is consensual, the latter is not. Of course, for a cash

[2]103 T.C. 634 (1994), *Doc 94-10228*, *94 TNT 223-15*, *aff'd without opinion*, 89 F.3d 856 (11th Cir. 1996), *Doc 96-19540*, *96 TNT 133-7*.

basis taxpayer, even the entry of the judgment does not give rise to income. Plainly, the judgment might not be paid.

Yet there is no question that the legal right to contingent attorney fees arises on the execution of a settlement agreement or entry of a judgment. That is the time the lawyer can no longer negotiate for a stream of payments and have it recognized for tax purposes. If the lawyer has the right to receive a lump sum, he can no longer negotiate for periodic payments.

In contrast, it is still possible to make changes in the nature and time of payment at any time before the execution of the settlement agreement. But against that settlement model, what about with court awarded attorney fees?

There will surely be fee applications filed with the court that set forth a tally of the many hours the plaintiff lawyers spent on the case. Those fee applications will also trumpet the success the plaintiff attorneys had in realizing an outsize recovery for the class. Yet until the court *orders* the legal fee into existence, there is no legal right to the fees.

The court order approving legal fees becomes the analog to a judgment for the plaintiffs. In a judgment, the court orders the defendant to pay the plaintiffs as specified in the judgment. Similarly, a court's award of attorney fees and costs to counsel orders the defendant to pay those fees and costs.

Constructive Receipt

Cash basis taxpayers generally do not have income until they receive cash. The constructive receipt doctrine operates as a necessary exception to this general rule.[3] The constructive receipt doctrine reduces the opportunity for manipulation that can occur when one party is ready to pay but the intended recipient requests payment at a later date.

How do structured legal fees stack up to constructive receipt? Basically, the constructive receipt doctrine comes down to control and legal rights. If the taxpayer has access to the income but chooses not to take it, the income is taxable. The classic example is the worker who refuses a paycheck at year-end, asking for payment in January. The check is clearly income in December, because he was entitled to it at that time.

On the other hand, a taxpayer can condition his willingness to sign documents on receiving money over time rather than in a lump sum. Therefore, there is no constructive receipt when a taxpayer insists he will sell his house only on the installment method. Likewise, there is no constructive receipt if a plaintiff refuses to sign a release unless the damages are structured.

The same principles apply to plaintiff lawyers. Of course, the attorneys must be precluded from withdrawing their attorney fees earlier than the scheduled payment dates. The documents must prevent the attorneys (or their beneficiaries) from accelerating, deferring, increasing, or decreasing their scheduled payments. The attorneys should have no right or power to receive any payment before the scheduled payments are made.

But those rules do not mean that one cannot structure an arrangement to provide security. The fact that an annuity is the asset from which the installment payments to the lawyer will be made does not change that. However, the annuity contract should not be owned or controlled by the attorney. Instead, the annuity should be owned by, and issued in the name of, the assignment company. That makes it difficult for the IRS to argue that the annuity contract is somehow ''set aside for'' or ''otherwise made available to'' the attorney.[4]

A solid line of case law supports deferred compensation arrangements when an employee makes an irrevocable election to defer compensation (such as bonuses, stock, commissions, etc.) before the amounts are determined or earned.[5] If the attorney agrees to the structured payment of attorney fees in the contingency fee contract, the attorney has clearly agreed to a deferred payment arrangement before his fees were earned. However, many contingent fee agreements are silent as to whether the attorney agreed to structure his fees. In those cases, the settlement agreement should include language stating that the attorney's election to receive his fees in structured installments is irrevocable.

Economic Benefit Doctrine

The economic benefit doctrine is distinct from the doctrine of constructive receipt and somewhat harder to understand. Yet it rests on a fundamental principle. If a promise to pay an amount is funded and secured by the payer and the payee needs only to wait for unconditional payments, the payee has a current economic benefit.

In that case, the payee must recognize income on the full value of the payments in the year the contract is signed.[6] That can be a harsh rule. Even

[3]Reg. section 1.451-2(a).

[4]Reg. section 1.451-1(a) and 2(a).

[5]*See Veit v. Commissioner*, 8 T.C. 809 (1947); *Commissioner v. Oates*, 207 F.2d 711 (7th Cir. 1953); *Robinson v. Commissioner*, 44 T.C. 20 (1965); *Martin v. Commissioner*, 96 T.C. 814 (1991).

[6]*Commissioner v. Smith*, 324 U.S. 177 (1945); *Drysdale v. Commissioner*, 277 F.2d 413 (6th Cir. 1960), *rev'g* 32 T.C. 378 (1959).

so, the economic benefit doctrine is based on the theory that a promise to pay deferred compensation in the future — in and of itself — can constitute income. The amount taxed is the amount of that obligation, discounted to present value.

A payee will be treated as receiving the current economic benefit of future payments when a separate fund or trust is established that is unconditionally and irrevocably dedicated to the payee. Therefore, in *Sproull v. Commissioner*,[7] the court found an economic benefit conferred on a taxpayer when the taxpayer's employer established a trust to compensate him for past services. The employer established a trust in 1945 to be paid to the taxpayer in 1946 and 1947. The court held that the taxpayer received current compensation equal to the value of the money transferred to the trust, because the transfer to the trust provided the taxpayer with an economic benefit.

However, not all rights to receive periodic payments trigger the economic benefit doctrine. For example, in Rev. Rul. 79-220,[8] the IRS concluded that a right to receive periodic payments did not confer an economic benefit on the recipient.

Section 83

Besides arguing those nonstatutory tax doctrines, the IRS in *Childs* also argued that section 83 independently dictated that the lawyers had immediate income for their fees. Section 83 codifies the economic benefit doctrine related to compensation for services. Clearly, attorney fees in a contingent fee case are compensation for the attorney's services.

Yet under section 83, the attorney fees are not taxable until those fees are vested or are no longer subject to a substantial risk of forfeiture. In *Childs* and in the numerous fee structures following its method, there are strong arguments that the defendant or defendant's insurer has not transferred property to the attorney constituting funded or secured promises to pay. There is therefore nothing to trigger taxation on the present value of the attorney fees under section 83.

The *Childs* court was satisfied that the owner of the annuity was the assignment company, not the attorneys. Indeed, the assignment company retained all rights incident to ownership, including the right to change the beneficiary (the attorney) while the beneficiary was still living. Further, the attorneys could not accelerate, defer, increase, or decrease their attorney fees (once structured) during the term of the payment period. As long as the assignment company remained the sole owner of the annuity and the attorneys have no rights under the policy greater than those of a general creditor, the attorneys should not realize the present value of the structured fees.

Court Awarded Attorney Fees

In the case of court awarded attorney fees, I am not aware of any case in which the courts have held that a cash basis lawyer or law firm has constructive receipt merely on a court's entry of an order of entitlement to the fees. Just as a judgment may be a court order imparting the legal right to a payment, the court may award legal fees in an order. Yet neither the judgment nor the fee award is actually payment.

A plaintiff has constructive receipt only when the defendant actually delivers payment or deposits the judgment amount into an account, and the plaintiff can receive or access that amount without compromising its rights. The same should be true of the lawyer. Some of the case law on the tax treatment of judgments appears to support that conclusion.

For example, in *United States v. Steck*,[9] individual plaintiffs obtained a judgment in 1956 for a condemnation award of $30,988, plus 6 percent interest. The Kansas Supreme Court affirmed the judgment in the same year. The defendant promptly deposited the principal, but not the interest, with the clerk of the court.

The plaintiffs did not withdraw the principal amount but instead sued the defendant for the unpaid interest. Eventually, the Kansas Supreme Court sided with the plaintiffs. In 1958, two years after the original judgment and deposit, the defendant paid the interest to the clerk of the court.

The clerk promptly disbursed the entire amount — consisting of the principal and the newly deposited interest — to the plaintiffs. The tax question was whether constructive receipt required the plaintiffs to include the principal amount of the award in their income for 1956, the year the defendant paid the principal to the clerk.

Both the trial and appellate court held that there was no constructive receipt on those facts. Under Kansas law, the taxpayer would have forfeited its claim to interest had the principal been subject to withdrawal. In fact, the clerk was prohibited from releasing the judgment until the full amount was paid into the court.

Significantly, it does not appear that the government even argued that the plaintiffs should have constructive receipt on the mere *entry* of the judgment. The judgment may be a legal right, but that

[7]16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952).

[8]1979-2 C.B. 74.

[9]295 F.2d 682 (10th Cir. 1961).

legal right was not the same as cash. That was true even though the judgment was affirmed by the Kansas Supreme Court. The IRS focused only on the plaintiffs' *access* to the funds.

The Tax Court applied a similar analysis in *Aldridge v. Commissioner*,[10] another case involving a payment of condemnation funds into a court. The court held that the plaintiffs did have constructive receipt in the year the money was deposited with the court. Yet significantly, the plaintiffs had the legal right to withdraw those deposited funds at any time without waiving any rights under state law. That arguably makes the *Aldridge* fact pattern further along the constructive receipt-economic benefit continuum.

Those cases sensibly suggest that a plaintiff has no constructive receipt immediately following the entry of a judgment, even when it appears that money is available to the plaintiffs. Plainly, at least when there are legal impediments to the plaintiffs withdrawing funds, it could not be otherwise. The plaintiff may work tirelessly to try to collect on a judgment, and should not be taxed until the plaintiff actually does so.

The same must be true for the attorney fee counterpart to a judgment: a court awarded fee. In both cases, the plaintiff and the lawyer have a legal right to money. In both cases they do not have unrestricted access to money or money's worth.

Importance of a Court Order

It may seem that a court order calling for a payment of attorney fees to class counsel would be dispositive, not of receipt, but of the *right* to receive funds. If an order of the court approves a fee award, it would seem important to determine if it calls for cash or a structure. Even though a court order can surely not be seen as payment itself, if there are no further legal documents to be signed to obtain the funds, the lawyers are presumably then entitled to a cash fee.

It could be argued that the funds could be taxable to them at that time, or more realistically, that it may be then too late to structure. The latter may be true even if the defendant agrees to pay a third-party assignment company rather than paying the attorney directly. The issue is not really whether the fees should be treated as received and taxable on the entry of the court order, but rather whether a court order suggesting that the fees are due and payable in cash means the attorney can no longer ask for periodic payments.

I think of that situation as analogous to a contract for the sale of my house calling for payment in cash. If I have already tendered the deed, it is clearly too late to ask for installment payments and to be taxed on an installment basis. But if I have a signed executory contract and I amend it to change the payment feature from all cash to installments, will the payments be taxed only as I receive them?

Some would argue that if the contract is signed and could be enforced by the buyer, it is too late to amend it and to effectively call for an installment sale. Of course, in the real world the buyer does not want to litigate and wants the deed consensually. The buyer may even be indifferent to whether the sale is for cash or installments.

Whether or not my house sale analogy is apt, a court awarded fee clearly would be capable of being structured if that court order *itself* specifies *how* it is to be paid. Ideally, the court order awarding the fee would be written in much the same way as a settlement agreement providing for a structured legal fee arising out of a settlement. With such a detailed and circumscribed court awarded legal fee there should be no concern of constructive receipt.

One would have a court order setting forth the entitlement to the fee and the specific manner in which it is to be paid. Of course, that puts a burden on class counsel to apply not only for the *size* of a fee but for the *nature* of the payment. Class counsel may know they want to structure but not yet know the specifics. In fact, the specifics may be dependent in part on how large a fee the court awards.

An alternative might be a fee award that calls for funds to be deposited into a qualified settlement fund from which the fees would be dispersed to counsel and annuity providers.[11] Other variations might include a fee award that says the fees will be paid in cash or via structures paid to third parties. Of course, in the latter case, the order is likely to cause some consternation if it appears that the lawyers can simply direct whether they want cash or a structure (or some of each as they request) without further involvement of the court.

Conclusion

Legal fee structures are now viewed by the IRS as vanilla in character. The IRS may not have liked them at one time, but the Service's ardor has changed materially since the *Childs* decision. In many cases, the IRS has cited *Childs* with approval.[12]

Given the barriers to receipt presented by the legal imprimatur of a court order for fees, there is

[10] 51 T.C. 475 (1968).

[11] For details, see Robert W. Wood, "Can You Form a Qualified Settlement Fund With a Judgment?" *Tax Notes*, Nov. 29, 2010, p. 1017, *Doc 2010-23248*, or *2010 TNT 231-8*.

[12] *See, e.g.*, LTR 200836019, *Doc 2008-18961*, *2008 TNT 174-22*.

no reason to believe properly structured attorney fees flowing from such an award would be attacked. The operative event should be the nature of the court order itself and whether it specifies a manner of payment. If it calls for periodic payments or for payments into a qualified settlement fund from which the structure is arranged, it should be respected and the lawyer should be taxed only on receipt of the periodic payments. Yet even if the fee award does not call for periodic payments, I can think of no reason why it should not still be possible to structure it.