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No-Admit Settlements and Deducting Bad Conduct

By Robert W. Wood

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Tax deductions by putative wrongdoers are often questioned in the media even if they are not proscribed by the tax law. Civil damages are deductible by businesses, as are punitive damages paid to private parties. But the public and the government have long debated the scope of the section 162(f) prohibition on deducting specific fines and penalties. Wood examines those authorities in light of *Fresenius* and the SEC's recent change in policy.

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The SEC now wants defendants not merely to pay but also to admit guilt in some cases. The about-face does not come in isolation. The agency has come under fire for its long-standing practice of settling civil litigation without requiring defendants to admit wrongdoing. Sen. Elizabeth Warren, D-Mass., has become a voice for claiming the system let defendants off too easily.[1]

Warren's complaint sounds a familiar refrain and concerns the question of whether allowing defendants to deduct settlement payments leads to indifference to wrongdoing. On the other side of the debate are those who say that the SEC requiring an admission of misconduct would undercut the agency's settlement authority and efficiency. For now, this debate is quelled.

On June 18, SEC Chair Mary Jo White announced that the SEC will require guilt admissions in some cases — a watershed development in SEC enforcement.[2] Exactly which cases will merit the special treatment will be determined case-by-case using three criteria: "misconduct that harmed large numbers of investors or placed investors or the market at risk of potentially serious harm"; "egregious intentional misconduct"; or "when the defendant engaged in unlawful obstruction of the commission's investigative processes."[3]

According to White, most cases will still be allowed to settle under the "neither admit nor deny" policy.[4] Of course, bear in mind that those are civil cases. Some, notably Warren, say allegations over blowups in the financial world deserve more serious treatment than a potential no-admission settlement. Another critic of the no-admission settlement is Judge Jed S. Rakoff of the influential U.S. District Court for the Southern District of New York. In 2011 Rakoff rejected a proposed deal by Citigroup that called for the bank to pay $285 million to settle SEC allegations that it misled investors in a 2007 mortgage bond deal.[5] That case is on appeal.[6]

Different rules apply if there is a parallel criminal case. In 2012 the SEC announced that it would no longer allow defendants to avoid liability if they had previously admitted transgressions in parallel criminal cases.[7] Requiring admissions of guilt in stand-alone civil cases is a startling development,

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[1]*See* Letter from Warren to Ben Bernanke, Eric Holder, and Mary Jo White, May 14, 2013.

[2]*See* Russell Ryan, "Why the SEC Needs 'No-Admit' Settlements," *The Wall Street Journal*, May 22, 2013, at A15.

[3]James B. Stewart, "S.E.C. Has a Message for Firms Not Used to Admitting Guilt," *The New York Times*, June 21, 2013.

[4]*See* interview by Francesco Guerrera with White, "Where the SEC Action Will Be," *The Wall Street Journal*, June 24, 2013, at R4.

[5]*SEC v. Citigroup Global Markets Inc.*, 827 F. Supp.2d 328 (S.D.N.Y. 2011).

[6]*SEC v. Citigroup Global Markets Inc.*, No. 11-5227 (2d Cir. 2012).

[7]*See* Robert Khuzami, "Public Statement by SEC Staff: Recent Policy Change," Jan. 7, 2012.

however.[8] Apart from public image issues, companies will doubtless worry that private civil litigation will follow those admissions.

It remains possible that some settlements will not proceed if an admission of wrongdoing is required. In settlement bargaining, most defendants consider a ''no-admit'' clause to be one of the most important.[9] They might not settle without it. As that debate simmers, tax advisers invariably think about deductibility. It is a broad and important topic hardly limited to SEC matters, and it arises in many government settlements.

Inevitably, there is a dichotomy between nondeductible punitive fines or penalties and deductible compensatory or remedial payments. Every few years a kerfuffle erupts over whether defendants in various types of government cases should be allowed to deduct their settlement payments.

After Boeing settled a case in 2006, Senate Finance Committee member Chuck Grassley, R-Iowa, went on a publicity-chasing warpath about why government settlement payments should not be deductible.[10] The *Boeing* case and others have led to more jockeying on the topic. Some, including Grassley, want to see all government settlements expressly address taxes.[11] However, others, including some government employees, do not or cannot comply with that kind of requirement.

In the case discussed below, the government made clear that it would not and could not agree to any tax characterization in the settlement agreement. Yet when the dispute turned specifically to the tax treatment of the settlement payments, the government claimed that the only way the defendant could deduct a settlement payment as compensatory was if the settlement agreement had expressly allowed it. Thus, sometimes the government is at odds with itself over the question. One needs a backup plan if the tax language in the settlement agreement is unavailable or if the parties would like to change it. Meanwhile, cases must be resolved and someone must consider what is deductible and what is not.

Fresenius

One case that tested this area was *Fresenius Medical Care Holdings Inc. v. United States*.[12] Fresenius, a provider of kidney dialysis services, settled with the government and resolved claims for criminal and civil healthcare fraud. The agreement included a criminal fine of $101 million and a civil settlement of $385 million.

Fresenius made and deducted its civil settlement payments in 2000 and 2001. The IRS disallowed 50 percent of the deduction as a nondeductible penalty under section 162(f). The IRS later allowed the company an additional deduction of approximately $69 million, which had been designated in the settlement agreement as relator fees. Those, after all, are inherently compensatory.

But Fresenius contended that there was no nondeductible penalty and sued for a refund. Fresenius asserted that the lump sum settlement was only double the government's claimed single damages and therefore compensatory. In a pretrial motion for judgment as a matter of law, Fresenius also argued:

> The United States is made completely whole in a False Claims Act [FCA] case only by recovery of a damage amount in excess of the ''single'' or ''actual'' damage amount representing the repayment of claims alleged to be false or inaccurate. Fresenius also submits that U.S. Supreme Court precedent makes clear that ''double'' damages are remedial in nature and the evidence elicited during trial in this matter establishes that the double damages were not punitive.[13]

The *Fresenius* settlement agreement contained the following provision, as is common in FCA settlements: ''Nothing in this Agreement constitutes an agreement by the United States concerning the characterization of the amounts paid hereunder for [tax] purposes.''[14]

The government argued that to deduct the payments, Fresenius must prove the parties agreed the damages were compensatory at the time of settlement. In the end, the court asked the jury to decide whether Fresenius had ''established by a fair preponderance of the evidence that some portion of the civil settlement payments . . . is not punitive for tax law purposes and consequently is deductible as an ordinary and necessary expense paid in carrying on a business.''[15]

The jury returned a verdict in favor of Fresenius for $95 million, less than the $126 million the company had sought.

IRS Response

There has been a dramatic rise in the importance, volume, and sheer size of FCA and other federal

[8] *See* Jean Eaglesham and Andrew Ackerman, ''SEC Seeks Admissions of Fault,'' *The Wall Street Journal*, June 19, 2012, at C1.

[9] *See* Ryan, *supra* note 2.

[10] *See* Robert W. Wood, '''It's Deductible': Sharp Pencils and Boeing's Imbroglio,'' *Tax Notes*, Sept. 18, 2006, p. 1053.

[11] Release, ''Grassley, Baucus Introduce Bill to Toughen Corporate Settlements,'' Apr. 28, 2003.

[12] 2013 U.S. Dist. LEXIS 66234 (D. Mass. 2013).

[13] Pl. Mot. Summ. J., Aug. 15, 2012, ECF No. 128.

[14] *Fresenius*, 2013 U.S. Dist. LEXIS 66234, at *20.

[15] Tr. 134, Aug. 15, 2012, ECF No. 139.

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government investigations and lawsuits, and IRS interest in the settlements has grown. In 2007 the IRS issued an industry director directive on the deductibility of some government settlements.[16] The directive specifically covers FCA settlements with the Justice Department and Environmental Protection Agency settlements for supplemental or beneficial environmental projects. In 2008 the IRS issued a coordinated issue paper.[17] The coordinated issue paper only addresses the deductibility of FCA settlements.

The IRS's issuing of both the industry director directive and coordinated issue paper suggests an increased focus on company practices regarding settlements. Not surprisingly, many companies deduct all of their settlement payments without allocating between compensatory and punitive payments.

Although the directive expressly covers only two kinds of settlements, its preamble states that its principles can apply to any settlement between a governmental entity and defendant under any law by which a penalty can be assessed. Meanwhile, the coordinated issue paper concludes that a portion of a civil fraud settlement may be a penalty and thus nondeductible under section 162(f). Determining that portion is primarily a question of government intent, according to the IRS.

The IRS says that the taxpayer bears the burden of proving its entitlement to a full or even a partial deduction. How does one discern the motive of the government on any subject, let alone prove it? Several cases are particularly important in exploring the purposes of a payment, although none is more important than *Talley Industries Inc. v. Commissioner*.[18]

In *Talley*, a company and its executives were indicted for filing false claims with the government. The claimed loss to the Navy was $1.56 million, but Talley and the DOJ settled for $2.5 million. When Talley deducted the settlement, the IRS claimed it was a nondeductible fine or penalty.

The Tax Court held that the settlement was deductible, except for the $1,885 explicitly characterized as restitution. The court found that the government had never suggested it was attempting to exact a penalty. Noting that $2.5 million was less than double the alleged $1.56 million loss, the court inferred that the settlement was not intended to be penal or punitive, but that it was compensatory.

The IRS appealed, and the Ninth Circuit reversed and remanded. Even though the settlement agreement was silent as to allocation, the Tax Court on remand concluded that the parties intended the settlement to include double damages under the FCA. The Tax Court then turned to whether the $940,000 double damages were intended to compensate the government for its losses or to deter or punish. Talley argued that none of the $940,000 could be considered a penalty, while the government argued all of it was.

After the parties presented a mishmash of evidence, the Tax Court concluded that Talley failed to carry its burden of showing an intended remediation purpose. This time, Talley appealed. The Ninth Circuit reviewed the Tax Court's conclusions of law *de novo* and its factual findings for clear error. Finding no clear error, the Ninth Circuit held that Talley had failed to establish the compensatory nature of the settlement.[19]

A taxpayer was similarly denied a deduction in *Allied-Signal Inc. v. Commissioner*.[20] Allied-Signal made an $8 million payment into a nonprofit environmental fund. The Tax Court found the payment nondeductible because Allied-Signal made it with the virtual guarantee that the sentencing judge would reduce the criminal fine by at least that amount.

In *Fresenius*, the district court cited as primary authority *United States v. Bornstein*[21] and *Vermont Agency of Natural Resources v. United States*.[22] The court said those cases showed that the first third of FCA liability — the single damages — represented direct compensation for the government's losses. The second third was categorically compensatory under *Bornstein*, while the last third was categorically punitive under *Vermont Agency.*

That rule seemed clear and concise, and the *Fresenius* court thought it was consistent with the provision of the FCA permitting the court to reduce treble damages to double damages in the case of a cooperative defendant.[23] Under a categorical view of the double damages portion as compensatory and the treble portion as punitive, the court maintained full discretion over whether punitive liability should be imposed on the defendant.

In *Cook County v. United States*,[24] however, the Supreme Court strayed from the categorical approach. The Court emphasized that the FCA's

[16]*See* LMSB-04-0507-042.
[17]*See* LMSB-04-0908-045.
[18]T.C. Memo. 1994-608, *rev'd and remanded*, 116 F.3d 382 (9th Cir. 1997).

[19]*See Talley Industries Inc. v. Commissioner*, 18 Fed. App. 661 (9th Cir. 2001), *aff'g* T.C. Memo. 1999-200.
[20]T.C. Memo. 1992-204, *aff'd*, 54 F.3d 767 (3d Cir. 1995).
[21]423 U.S. 303 (1976).
[22]529 U.S. 765 (2000).
[23]31 U.S.C. section 3729(a)(2).
[24]538 U.S. 119 (2003).

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"damages multiplier has compensatory traits along with the punitive."[25] As recognized in *Bornstein*, "some liability beyond the amount of the fraud is usually necessary to compensate the Government completely for the costs, delays, and inconveniences occasioned by fraudulent claims."[26]

Thus, the *Cook County* Court refused to conclude that any portion of multiple damages under the FCA is necessarily remedial or punitive. Instead, the Court saw the task of characterizing multiple damages as a fact-dependent inquiry. The Court said that the "FCA's treble damages remedy is still 'punitive' in that recovery will exceed full compensation in a good many cases."[27]

Yet the Court decried easy line-drawing, stating that the "tipping point between payback and punishment defies general formulation, being dependent on the workings of a particular statute and the course of particular litigation."[28] Multiple damages can serve remedial purposes rather than purely punitive goals because they may be necessary to make the government whole. The facts of any particular FCA litigation must be considered.

Settling FCA Liabilities

The *Fresenius* court noted that settling FCA claims — or presumably any claim — adds complications. However, every business knows there is value in avoiding the costs and risks of litigation. In *Fresenius*, the government argued that *Talley* held that the parties must expressly agree on the purpose of a settlement payment to characterize it as compensatory.

Sensibly, the *Fresenius* court held that an agreement is unnecessary. In other words, payments can be non-punitive FCA payments without an agreement. Because the FCA does not categorically determine the purpose of the payments, a fact-finder must determine to what extent multiple damages are compensatory.

How does one do so? We know that a settlement agreement is relevant, yet the parties' stated intent in a settlement agreement is not dispositive. For example, if the case had been litigated, examining the potential characterization of liability may shed light on whether settlement payments were made to resolve compensatory or punitive liability.

The Supreme Court in *Cook County* explained that the need to compensate the government for *qui tam* relators' fees, interest, and consequential damages might render multiple damages remedial.[29] The prejudgment interest or consequential damages necessary to make the government whole may be large. The entirety of a treble damages award could be compensatory, leaving only the civil penalty portion of FCA liability as the punitive component.

The *Fresenius* court noted that a fact-finder could find it more likely than not that settlement payments made to resolve the liability had a compensatory purpose. Besides, the DOJ expressly declined to resolve the question of tax liability contemporaneously with the settlement of the underlying civil liability, the court said. The DOJ had stated from the outset that: "The United States Attorneys' Offices, Department of Justice components, and related federal agencies involved in this investigation are without authority to resolve any tax matter relating to these discussions and any underlying conduct by NMC."[30]

The DOJ refused to resolve the characterization of the settlement payments for tax purposes as part of the settlement. Under the government's approach, the DOJ thus ensured that the settlement could not be compensatory because it refused to characterize the payments. It was the DOJ's unilateral refusal to resolve tax matters that led the *Fresenius* court to decide those very same matters in the government's favor. The court could not agree.

The *Fresenius* court did say that a characterization agreed on by the parties, or announced by a judicial officer, may well be determinative for taxation purposes.[31] In addition to or in lieu of that, the parties' negotiations may provide evidence of the compensation due 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 look also to the non-contractual evidence regarding the purpose and application of the payments.

The Settlement Agreements

In *Fresenius*, the civil agreements stated that Fresenius and its subsidiaries "agree that nothing in this Agreement is punitive in purpose or effect."[32] This phrase could be read to mean non-punitive for the purposes of the double jeopardy and excessive fines clauses. The Supreme Court has "long recognized that the Double Jeopardy Clause does not prohibit the imposition of all additional sanctions that could, 'in common parlance,' be described as punishment."[33]

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[25]*Id.* at 130.
[26]*Id.*
[27]*Id.* at 131.
[28]*Id.* at 130.
[29]*Id.* at 130-131.
[30]*Fresenius*, 2013 U.S. Dist. LEXIS 66234, at *19.
[31]*Compare Stephens v. Commissioner*, 905 F.2d 667, 673 (2d Cir. 1990) (characterizing award of restitution as compensatory based on the intent of the sentencing judge).
[32]*Fresenius*, 2013 U.S. Dist. LEXIS 66234, at *22.
[33]*Hudson v. United States*, 522 U.S. 93, 98-99 (1997).

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Yet non-punitive for purposes of the double jeopardy clause does not mean non-punitive for purposes of the Internal Revenue Code.[34] Moreover, other provisions within the settlement agreements expressly stated that they did not characterize the settlement payments as non-punitive for tax purposes. Given that, what else is relevant?

Other Evidence

The *Fresenius* court considered negotiations and statements by various advisers and participants. None of the statements established as a matter of law that the settlement payments were not compensatory, nor did they demonstrate knowledge on the part of Fresenius's lawyers about expenses the government incurred to investigate the FCA violations.

None of the statements indicated knowledge about the interest rate that represented the lost opportunity cost to the government from the delayed payments. Moreover, none of the statements established the extent to which the settlement paid the government for its losses or the extent to which the settlement exceeded those losses. To the contrary, *Fresenius* raised a genuine dispute of material fact regarding whether some of the multiple damages were compensatory.

The documents exchanged in settlement negotiations, for example, suggested that making the government whole would have required payment of substantial amounts of prejudgment interest. Statements from Fresenius's attorneys further supported the proposition that the multiple damages, at least in part, were compensatory.

At trial Fresenius emphasized language in the agreements that indicated the payments were not punitive. It argued that the multiple damages were designed to compensate the government, primarily for prejudgment interest. The government argued that Fresenius could not prove the compensatory nature of the payments without an express agreement of the parties. The government also tried to rebut the assertion that multiple damages were designed to compensate the government for interest.

Given the mixed evidence about the extent to which the disputed settlement payments were remedial, the *Fresenius* court sent the case to the jury. The jury found that $95 million of the disputed $126,796,262 in settlement payments was compensatory and therefore deductible. The jury struck a balance between the compensatory and punitive intent of the payments, but one that was in Fresenius's favor.

Conclusion

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 a tax adviser and in-house legal officer. What will you do if the government refuses to insert explicit tax characterization language in the settlement agreement itself, and then later asserts that the only way you could have the payment treated as compensatory is to have had express language?

Plainly, one should retain supporting correspondence and documents, but be thoughtful and careful about what you say. Something short of an agreement in writing in the settlement agreement may be helpful. 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 with the relative certainty of the rest. If you are selecting an amount that will be nondeductible, try to have a theory on how you got there. Be consistent. Remember that if you insist on all or nothing, sometimes you get nothing.

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. You may 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, or even 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 that occur contemporaneously with the settlement. Lawyers and company officials can be appropriate signatories for those items. This is done far less frequently than it should be. To give them added gravitas and perhaps even admissibility, consider preparing and signing them under penalties of perjury.

Consider all these items early as you are negotiating a settlement. Documents prepared at tax return time — or even worse, at audit time — are never as persuasive.

[34]*Talley*, 116 F.3d at 387.

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