PERSPECTIVE

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What Lawyers Should Know About Structured Legal Fees

By Robert W. Wood

A "structured legal fee" sounds like a Wall Street product. Actually, it is largely a creature of the life insurance industry. Every lawyer should know what it is and what it is not.

To start, only plaintiffs' lawyers can take advantage of structuring their fees. Defense lawyers cannot, although they still need to know how fee structures work. After all, defense lawyers and their defendant clients will be asked to accommodate these financial arrangements in settlement agreements.

The language and mechanics can seem strange. The defendant pays a third-party annuity provider and the lawyer receives the right to receive a stream of payments over a set number of years or for life. Structures offer tax, investment and asset protection advantages.

Plaintiffs' lawyers charging a contingent fee are in a unique position to plan their income and save taxes. Virtually no other service provider can arrange a funded payment over time that the Internal Revenue Service will respect. What's more, all of the necessary arrangements can be done on the eve of settlement.

Axiomatically, the attorney must elect to defer the fees before they are earned. Once the settlement agreement is signed, it is too late to structure fees. Fortunately — and somewhat unrealistically — the lawyer is generally not treated as "earning" a contingent legal fee until the settlement agreement is signed.

Many plaintiffs' lawyers will have good and bad years. Many lament the unpredictability of their income and many desire to level it out. Structured legal fees can allow a lawyer to select how much of a fee he or she wants to accept this year versus in the future.

A primary goal is to save taxes. A structure impacts when the fees are taken into income and defers taxes on the investment earnings on those fees. As importantly, structured legal fees allow pre-tax investing, locking in pre-tax investment return.

Significantly, the lawyer is not relying on installment payments from a defendant or a client. There is virtually no risk that the payments will not be made. The fee will be paid by the defendant to a third party for the purchase of annuities benefiting the attorney. In a sense, the lawyer has "earned" the fee over the course of the case.

Nevertheless, the tax law assumes that the lawyer has not fully earned the fee until the settlement documents are signed. The leading tax case is *Childs v. Commissioner*, 103 T.C. 634 (1994); *affirmed without opinion*, 89 F.3d 856 (11th Cir. 1996). In *Childs*, as in most fee structures, the settlement documents required the defendant to pay a third-party annuity provider that had agreed to pay the lawyers over time.

The IRS argued that the attorneys in *Childs* were entitled to their fees in cash. The IRS said they had "constructively" received the payments. However, the tax court and the 11th U.S. Circuit Court of Appeals ruled that the settlement documents controlled the timing of the income and that the doctrine of constructive receipt was inapplicable.

The IRS lost in *Childs* and has since given up on attacking properly structured legal fees. In its wake, legal fee structures have boomed. Because of tax-free compounding, the longer the attorney stretches out payments, the better the financial result.

A legal fee structure can function as a type of retirement account that is unlimited in scope. There is almost infinite flexibility in amounts and in distribution schemes. Payments might commence immediately and continue for five, 10 or 15 years.

Alternatively, payments might be deferred entirely for 10 or 15 years to build up tax-free. Thereafter, they will begin paying annually for the attorney's life or jointly with the attorney's spouse. There are no minimum or maximum distributions.

However, legal fee structures are rigid in documentation. The form and timing of fee structures are important. Again, it is necessary that the lawyer agrees to a fee structure before the client signs settlement documents.

Optimally, the contingent fee agreement should specify that the lawyer can elect to structure fees at the conclusion of the case. However, if the fee agreement does not contain such a provision, the agreement can be amended, even immediately before the settlement. As a technical tax matter, the lawyer has not "earned" his or her fee until the settlement documents are signed.

As a result, the lawyer, client and defendant can all agree that some of the lawyer's fee will be paid to an annuity issuer and the IRS will respect it. Although the lawyer cannot "own" the annuity contract, the lawyer will be designated to receive all of the payments. If the lawyer is not a solo practitioner and practices in a firm, the firm is probably entitled to the fee.

In some cases, the law firm will implement the structure and will receive the periodic payments. The law firm can thereafter pay the periodic payments to the individual lawyer as received. More commonly, though, even if the plaintiff law firm is technically entitled to the legal fee, the structured fee arrangements will individually be implemented for individual plaintiff attorneys.

An additional clarifying agreement can help avoid confusion between the firm and its partners or shareholders. In that sense, legal fee structures can actually help law firms to timely sort out which lawyers are entitled to which portions of a recovery. When paid to the firm, legal fee structures can help provide glue to keep a firm together.

Legal fee structures can also be accommodated in cases where defendant monies are deposited into a qualified settlement fund, also known as a QSF or Section 468B trust. QSFs allow for a kind of tax-free intermediary step after defendants pay and before the proceeds are distributed to the plaintiffs. Neither the plaintiffs nor their lawyers are taxable on the money while it remains in the QSF.

QSFs allow multiple plaintiffs and their lawyers to agree on a precise division of proceeds and on the time and manner of payment. QSFs are useful for many reasons and provide enormous flexibility for plaintiffs and their lawyers. The defendant gets an immediate tax deduction while the plaintiffs continue to resolve their differences. QSFs can give plaintiffs and their lawyers time to choose their desired form of payment.

Plaintiff attorneys who are unfamiliar with legal fee structures should start considering them. There are relatively few devices that allow income earners to push off income into the future without running serious risk. Legal fee structures do just that.

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