

MEMORANDUM

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To: NACA Tax Initiative Working Group
Date: July 22, 2014
Subject: Model Fee Section for Retainer Agreements

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One avenue the Tax Initiative is pursuing in order to change the tax treatment of attorney's fees is creating language for the fee section of retainer agreements that effectively shifts the taxability of attorney's fees from plaintiffs to their attorneys. This memo (i) explains the mechanics of this strategy; (ii) discusses some concerns regarding this approach; and (iii) offers a draft of model language for retainer agreements for review and comment.

I. Mechanics

As discussed in my last memo, one of the most important tax principles underlying the tax treatment of attorney's fees is the assignment-of-income doctrine. Under this doctrine, the only way one taxpayer may effectively transfer income to another is if the asset producing the income is itself transferred. In the case of attorney's fees paid under fee-shifting statutes, the income-producing asset is the statutory or common-law legal claim for attorney's fees. Accordingly, the only way to transfer the taxability of amounts paid under this claim is to convey the claim itself.

The Internal Revenue Service ("IRS") has suggested that such a conveyance would effectively shift the taxability of attorney's fees. In its brief in the *Banks* case, the government wrote:

This Court indicated in *Jeff D.*, however, that a prevailing plaintiff may be free to assign his statutory claim for attorney's fees to his attorney, see 475 U.S. at 730-731 (noting Congress "did not prevent the party from waiving this eligibility [for attorney's fees] anymore than it legislated against assignment of this right to an attorney"), and such assignments are not uncommon. Once such an assignment has occurred, courts generally permit the lawyer to sue on his own behalf to recover his fees, without the participation or consent of the prevailing party, see, e.g., *Carpa, Inc. v. Ward Foods, Inc.*, 536 F.2d 39, 52 (5th Cir. 1976); *Goodman v. Heublein, Inc.*, 682 F.2d 44, 47-48 (2d Cir. 1982). If such an assignment is viewed as a transfer of the

entirety of the attorney's fee claim to the lawyer, such that the prevailing party retains no meaningful interest in or control over the claim, then it may be possible to view any recovery on that claim as income only to the lawyer.¹

As such, one goal of revising retainer agreements is to assign the claim for attorney's fees to the attorney.

Additionally, to effectuate the desired tax treatment, retainer agreements would also have to ensure that clients do not have concurrent obligations to pay their attorneys. If they do, then any amounts paid under the assigned legal claim may be deemed as relieving the client of a debt owed to the attorney. Such relief from indebtedness would be income to the client.

Thus, the reworked retainer agreement must (1) assign the legal claim to attorney's fees to the attorney, and (2) not require the client to pay the attorney any other amounts. If we are able to create a retainer agreement that accomplishes both of these goals, we may consider seeking a ruling from the IRS that the agreement effectively transfers the taxability of attorney's fees from clients to their attorneys.

II. Concerns

Although a reworked retainer agreement may successfully change the tax treatment of attorney's fees, there are a number of non-tax considerations that may impact the feasibility of this approach. These concerns include: (a) whether the legal claim may be assigned as a matter of law; (b) whether such an assignment violates any rules of professional conduct; and (c) whether such an assignment adequately protects both the attorney and the client.

A. Validity of Assignment

Whether the legal claim to attorney's fees may be assigned as a matter of law depends on a number of distinct issues. First, there is a question of whether the claim for attorney's fees may be severed from the rest of the claim to which it attaches. Second, there is a question of whether the severed claim may be assigned under state and federal law. Finally, we must assess the implications of any limitations on assignment.

1. *Severability.* Under most consumer protections statutes (e.g, FCRA, FDCPA), the claim for attorney's fees is embedded in a larger statute. There is no clear guidance one way or another as to whether it may be treated as an individual claim or only as part of the larger

¹ Reply Brief for Petitioner at 19-20, *Comm'r v. Banks*, 543 U.S. 426 (2005) (Nos.03-892 and 03-907).

claim brought under the statute. This silence does not offer any indication as to whether the claim for attorney's fees may be assigned individually.

Analogizing to other fee-shifting federal statutes suggests that at least part of the claim is independently assignable. In two cases dealing with the assignability of claims for attorney's fees under 42 U.S.C. § 1988, the Ninth Circuit has held that at least part of the claim for attorney's fees may be assigned individually to the plaintiff's attorney.²

Thus, while there may be some concerns about the severability of the claim for attorney's fees, there is no clear indication that such severability is impermissible.

2. *State and Federal Law.* The assignability of claims for attorney's fees also depends on state and federal law. Each state has its own laws on and public policy concerns regarding the assignability of legal claims as well as the applicability of the doctrines of barratry, champerty, and maintenance. I encourage members of the working group to advise as to whether the assignment of claims for attorney's fees would raise concerns in their jurisdictions.

My research has found no federal prohibition on the assignment of claims for attorney's fees to an attorney. Neither the FDCPA nor the FCRA contains any explicit prohibitions on assignment of claims; and there does not appear to be a general blanket prohibition on such assignments.

In 2012, the Seventh Circuit held that the assignment of an entire claim under the FDCPA to a non-lawyer was void as against Illinois' public policy. Its decision, however, emphasized that the purported assignment was void because its goal was to allow for a non-lawyer "to practice law without a license;"³ a concern that is not applicable in the assignment of a claim to an attorney. As with state law, I encourage the working group to advise if they know of any federal rules that would limit the assignment of a claim for attorney's fees.

3. *Implications.* Even if all or part of the assignment were invalid as a matter of law, such a result may not impact its effectiveness for tax purposes. Federal income tax law does not

² See *Pony v. Los Angeles*, 433 F.3d 1138 (9th Cir. 2006); *United States v. \$186,416.00*, No. 07-56549 (9th Cir. 2013). Both cases contrasted between "the right to collect fee awards, which can generally be freely assigned, and the right to assign the right to seek or waive attorney's fees, which cannot be transferred." *United States v. \$186,416.00* at 7, citing *Pony* at 1144-45. It is not clear whether such a distinction would apply to consumer fee-shifting statutes; whether the underlying policy concerns are applicable outside the context of 42 U.S.C. § 1988; or whether the rationale was unique to California law, under which the cases were decided.

³ *Todd v. Franklin Collection Service, Inc.*, No. 11-3818 (7th Cir. 2012).

always correlate with state or other federal laws.⁴ Accordingly, even if the assignment weren't valid for other purposes, it may still be valid for federal income tax purposes.

B. Rules of Professional Conduct

A number of members of the working group have raised concerns that assignment of claims for attorney's fees could violate states' rules of professional conduct. Specifically, they expressed concern that if an attorney owns any part of a legal claim, such ownership could violate Model Rule 1.8(i), which states that "A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client."

Lee v. Javitch,⁵ an FDCPA case from the Southern District of Ohio, offers some comfort that such an assignment may not violate this rule. In *Javitch*, the plaintiff's fee agreement with her attorney stated that the attorney would only be entitled to an amount dependent on the statutory right to attorney's fees. Although there was no assignment, the defendant challenged the plaintiff's ability to seek attorney's fees arguing that the attorney had "'bargained for the Plaintiffs right to recover the entire statutory fee award for themselves.' [And that s]uch a bargain is not a reasonable contingent fee in a civil case, but amounts to a '*proprietary interest in the cause of action or subject matter litigation the lawyer is conducting for the client.*'"⁶

The court rejected this argument, noting the inherent tension between attorneys and their clients under fee-shifting statutes:

Modern fee-shifting statutes unavoidably create some tension between a plaintiff's goal of redressing an injury, and her attorney's desire to be paid for services rendered. This is especially true in the context of consumer statutes like the FDCPA, where the majority of cases involve statutory violations that cause no personal injury, and which support only modest statutory recovery. The ability to recover attorney's fees in these cases encourages competent counsel to accept these representations in order to vindicate consumers' rights. *Lee's counsel have clearly stated that they agreed to accept only what this Court might award if Lee was successful in her claims. This arrangement does not, in this Court's view, amount to an improper acquisition of a proprietary interest in Lee's cause of action.*⁷

As an assignment of the claim for attorney's fees would have the same effect as the arrangement in *Javitch*, the case offers support for the proposition that such an assignment would not violate Model Rule 1.8(i). That being said, we should explore this concern in more detail and I encourage

⁴ See, e.g., *O'Brien v. Comm'r*, 38 T.C. 707, 712 (1962) ("[W]e think it doubtful that the Internal Revenue Code was intended to turn upon [the] refinements [of state law].").

⁵ 568 F.Supp.2d 870 (S.D. Ohio 2008).

⁶ *Id.* at 873 (emphasis added).

⁷ *Id.* at 874-75 (emphasis added).

the working group to weigh in and consider seeking advisory opinions from state bars regarding this issue.

C. Practical Concerns

Finally, we must assess whether a reworked retainer agreement would impact either the attorney or the client from a practical perspective. Some concerns that members of the working group have raised include: (1) whether assignment of claims for attorney's fees would increase Rule 68 offers; (2) whether attorneys can guarantee that they will receive their fees; and (3) whether clients will retain their autonomy in making decisions about their cases. As the working group members have far more experience with these issues than I do, I encourage comments and concerns regarding these issues.

III. Draft Fee Section for Retainer Agreement

Below, I have drafted model language for the fee section of retainer agreements that attempts to address the concerns raised in this memo. Paragraph 1 of the model fee section addresses the tax issues raised in Part I of this memo by (i) assigning the claim for attorney's fees to the attorney, and (ii) stating explicitly that the client owes no debt to the attorney; paragraph 2 delineates the ways in which the claim will be paid upon recovery, thereby minimizing ambiguity in the case of settlement; paragraph 3 is a traditional provision for costs and expenses; paragraph 4 provides for the ordering of payment upon recovery, thereby guaranteeing that attorneys receive their fees; and paragraph 5 stipulates that in the case of early termination, the attorney will assign the claim back to the client, and the client will pay the attorney the fair market value of any services rendered until that point, thereby maintaining clients' autonomies over their cases.

Fees and Expenses

1. Under relevant law, Client has a legal claim that requires Defendant to pay Client's attorney's fees if Client prevails in its case. Client hereby assigns this claim to attorney's fees to Attorney. Pursuant to this assignment, Defendant -- and not Client -- will pay Attorney any and all fees for Attorney's services as awarded by the court or other relevant adjudicating body, or as agreed upon by the parties through settlement. Such amount will constitute the only fees to which Attorney is entitled; and Client will owe no debt to Attorney for Attorney's services.
2. Depending on the outcome of Client's case, Defendant may pay such attorney's fees in one of two ways:

- a. If the court or other relevant adjudicating body orders Defendant to pay a specified amount of attorney's fees, such amount will constitute payment under the legal claim that has been assigned to Attorney.
 - b. If Client reaches a settlement with Defendant, a portion of such settlement will constitute payment under the legal claim that has been assigned to Attorney. This portion shall equal the fair market value of Attorney's services, as determined in Attorney's sole reasonable discretion, [but generally X% of the settlement,] and may constitute a significant portion of the total recovery.
3. Attorney will advance all costs and expenses in Client's case (including, but not limited to, postage, filing fees, long distance calls, legal research, law clerks, copies, court reporters, process servers, and expert witnesses). In the event of a recovery, Client agrees to reimburse Attorney for said costs and expenses out of Client's share of the recovery.
4. Any recovery in Client's case, either by judgment or settlement, will be disbursed as follows:
 - a. first, Attorney will be reimbursed for all costs and expenses incurred, paid or payable in the case on Client's behalf;
 - b. second, attorney's fees will be paid to Attorney; and
 - c. third, any remaining funds will be paid to Client.
5. If Client terminates Attorney's representation before any recovery:
 - a. Attorney agrees to assign the legal claim for attorney's fees to Client; and
 - b. Client agrees to pay Attorney the fair market value of Attorney's services performed until the time of termination, as determined in Attorney's sole reasonable discretion.