ATTORNEY FEE STRUCTURES

By Thomas Girardi & Patrick Farber

The business model for a litigation law firm is often fraught with uncertainty — periods of big wins and big payouts as well as slow times with little or no income. One tool to even out cash flow, better manage the ups and downs of a litigation practice and prepare for an attorney's future financial needs is structured attorney fees.

Paving The Way

The Periodic Payment Settlement Act of 1982 (Public Law 97-473) gave injured parties the choice to receive a settlement in one lump payout or to receive periodic payments or a combination of cash and structured payments arranged through a structured settlement insurance annuity. These annuities are guaranteed to provide a steady stream of secure, tax-free income for the injured party over time.

The tax guidelines for attorney fee structures in personal injury cases came later in *Childs v. Commissioner*, 103 T.C. 634 (1994), affirmed 898 F3d 856 (June 11, 1996). The tax court held that attorney fees from personal injury cases could be received in periodic payments.

Instead of receiving a lump-sum payment at the end of a personal injury or workers' compensation case, attorneys can elect to receive their entire fee or a portion of their fee over a set time through an annuity. The annuity is purchased from a high-rated insurance company. Attorney fees are paid through an assignment company (typically an affiliate of a life insurance company) that will purchase an annuity from the affiliated insurance carrier to fund the obligation. This assignee then takes over the liability from the defendant in the case and begins making payments to the plaintiff's attorney according to the agreed upon payment schedule.

A structured fee plan is separate from the injured party's structured settlement plan. Attorneys receive their own annuity contracts and payment schedules while their clients receive separate annuity contracts and benefits. The two are not comingled.

Attorneys can receive structured fees regardless of whether their client selects a lump sum settlement option or a structured settlement. Only contingent fees that come out of the client's damage award qualify for fee structuring. Billable hourly fees cannot be structured.

In a relatively new twist, structuring fees are also being created in non-injury (non-qualifying) cases. While many large life insurance companies write attorney fee-structured annuities in personal injury cases, it is also feasible to write attorney fee structured annuities for just about every type of non-qualified case — as long as the attorney fee agreement meets with the insurance company's specific criteria. This means fees generated from class action settlements, cases involving environmental claims, construction defect, age, sex and employment discrimination, property damage, fraud and non-physical injury cases — in addition to personal injury cases — can all qualify for fee structuring.

Timing And Taxes

Since attorney fees comes out of the client's damages, the decision to create a structured fee schedule is best done prior to the completion of the settlement (structured or not). The creation of an annuity for attorney fees must be handled in the same manner as an annuity for an injured client. Funds for the structured fee annuity must come from the defendant (or its insurance company) and go directly to the life insurance carrier issuing the annuity.

While similar to an injured party's structured payment schedule, attorney fee payments do not enjoy the same tax-free benefits. However, proceeds from the annuity are taxed-deferred with taxes due only in the year they are received.

Not surprisingly, the IRS has strict reporting requirements regarding structured fees. Income from the annuity must be reported to the IRS annually on IRS Form 1099. The form is provided by the life insurance company.

Fee Structure Benefits

Structuring a fee has its benefits beyond its possible tax advantages. Structured payments give law practices guaranteed cash flow. They fund large expenses such as a child's education or provide a stable retirement income stream. Payment amounts can be increased annually to take into account inflation and can be paid to the firm directly, to individual firm attorneys or a combination.

Providing stable firm revenues can be one of the most appealing outcomes of a fee structure. Knowing that the firm will receive guaranteed income makes decisions on whether to accept a large contingency case a little easier. The decision can be based on case merits instead of whether the firm can weather the significant financial outlay required to manage these types of cases.

In one example, a 40-year-old sole practitioner was owed $750,000 in contingency fees. Instead of receiving a fully taxable lump sum, he decided to take $150,000 immediately in cash and spread the remaining $600,000 balance over seven years thus ensuring predictable cash flow to his small practice. Beginning in 2015, he will receive $7,529 monthly payments with the $600,000 becoming a $632,454 guaranteed benefit.

In another case, a 50-year-old attorney decided to structure $200,000 of her total fee. The attorney will delay receiving the $200,000 portion until she reaches age 70 (and presumably retires). The money is compounding at 3.61 percent during those 20 years so the $200,000 becomes a guaranteed benefit of $456,295. When she turns 70, she will receive at least $1,901 a month for 20 years. Her marginal tax bracket may be lower by the time she retires so she will pay less tax on the fee proceeds. Spreading out income over a number of years cam possibly reduce her tax obligation even more.

Finally, a 44-year-old attorney set up annuity payments from a $75,000 fee to coincide with his son entering college in 11 years During his son's four years in college, the attorney will receive $28,504 annual payments (the $75,000 compounds to $114,018 at 3.42 percent over 14 years) and he can use the funds to pay his son's tuition.

Weighting The Pros & Cons

With long-term U.S. Treasury notes currently yielding less than 4%, attorneys may be hesitant to tie up fee proceeds in an annuity when interest rates are expected to rise. While the peace of mind that comes with guaranteed, long-term payments is the most often cited benefit of structured fees, one way of reducing investment risk in a rising interest rate environment is to take a significant portion of the fee in cash.

The ability to create a guaranteed income stream through structuring offers financial security and stability, while the income's tax-deferred status can reduce an attorney or law firm's overall tax burden. Attorneys need to consult with their tax professional to determine whether a full or partial tax-deferred fee structure can help meet their individual or firm's financial needs.