

Chapter 12 Special Considerations in Settlements

§ 12.01 Attorney fee award disposition in settlement

Most cases are settled; not tried. If a statute or case law regarding your lawsuit provides for an award of attorney fees to the prevailing party, take special notice of that law during your negotiations for settlement. If you are not explicit during settlement, questions arise whether the settlement was intended to include attorney's fees, and whether attorney fees were waived.

In the settlement agreement make it clear whether:

- ✓ there is a waiver of attorney fees as a part of the settlement, or
- ✓ the amount of attorney fees has been agreed upon, or
- ✓ the issue of attorney fees is outstanding — and the court retains jurisdiction of the case to decide that issue.

Most commonly, when cases are resolved by a settlement agreement, the parties end the case by a stipulation of dismissal. In *Kokkonen v. Guardian Life Insurance Co.*,¹⁴⁷ the dismissal order entered by the parties' agreement neither incorporated the terms of the settlement in the body of the order nor reserved enforcement power in the court. The *Kokkonen* case held that enforcement of the settlement agreement was not a matter of a renewal or continuation of the original case but rather an entirely new contract breach cause of action. As such, the alleged breach of the settlement agreement had to be brought as a new action, one that the federal *Kokkonen* court observed would have to be brought in state court, because no federal cause of action was involved in a simple breach of contract case. So unless jurisdiction of the case is reserved to the trial court to enforce the settlement agreement, there will be problems of enforcement.


There is a further problem for the party that believes they prevailed in obtaining the settlement, perhaps even a settlement providing 100% of everything sought in the pleading filed in the case. If you are not a "prevailing party," then you are not entitled to an amount for attorney fees. You do not qualify as a "prevailing party" because of a settlement agreement — unless the settlement agreement is incorporated into an order of a court. In the federal courts, *Buckhannon v. West Virginia Department of Health and*

¹⁴⁷ 511 U.S. 375 (1994).

Human Resources,¹⁴⁸ mandated that unless a court has issued an order which creates a "material alteration of the legal relationship between the parties" or "a judicially sanctioned change in the legal relationship of the parties," then there is no "prevailing party" for an award of attorney fees. State decision law is tending to follow this pattern for the future. In short, if you represent the plaintiff, do not settle and dismiss the case, expecting an attorney fee to be awarded by the court because your settlement agreement paid the plaintiff money and everything else the plaintiff wanted.

On the other hand, if the settlement agreement is incorporated into the dismissal order, and the court retains jurisdiction to enforce the terms of the agreement in the order of dismissal, then the court's order of dismissal based on the settlement agreement becomes the legal equivalent of a consent decree on the merits. Note the two separate requirements: incorporation into the decree, and the court's retention of enforcement powers.

In a consent decree on the merits, a winning party can be a "prevailing party."¹⁴⁹ A consent decree, in an appropriate case, may serve as the basis for an award of attorney's fees. If the consent decree does not include an admission of liability by the defendant, there needs to be some court-ordered change in the legal relationship between the parties.¹⁵⁰ To define a plaintiff as a "prevailing party," defendants could agree to a declaration ordered by the court's consent decree that plaintiffs have certain rights or that defendant's procedures will be improved, or both. If there is neither a declaration of rights, nor an ordered change in what defendant will do in the future, nor an admission of liability, a court in an enforcement proceeding may decline to find the plaintiff was a "prevailing party" or award attorney fees.

 **WARNING.** If the defendants insist on a nonadmission-of-liability clause in a settlement agreement, plaintiffs' counsel should insist three items: (1) additional or more specific language defining and implementing relief, (2) a specific agreement that plaintiffs are the prevailing party, and (3) a specific agreement that plaintiffs are entitled to attorney fees. Each of these three items must be included; otherwise a

¹⁴⁸ 532 U.S. 598, 604 (2001)

¹⁴⁹ Cf., *American Disability Association v. Chmielarz*, 289 F.3d 1315, 1319–21 (11th Cir. 2002) (either by adopting the terms of the settlement in the court order or by expressly retaining jurisdiction, parties obtain the functional equivalents of consent decrees); *Board of Trustees of Hotel and Restaurant Employees Local 25 v. Madison Hotel*, 97 F.3d 1479, 1483 (D.C. Cir. 1996) (whether a mere reference to the existence of a settlement in the dismissal order is sufficient to retain jurisdiction is unclear, and the parties also should expressly provide that the court retains jurisdiction); and *Kokkonen v. Guardian Life Insurance Co.* 511 U.S. 375 (1994) (noting that if the explicit terms of the settlement agreement had been incorporated into the order of dismissal or if the order had provided for continued jurisdiction over the settlement, then the lower court would have had the authority to enforce the agreement, but not noting that such authority would make the plaintiff a prevailing party.)

¹⁵⁰ See *Maher v. Gagne*, 448 U. S. 122 (1980); *Texas State Teachers Assn. v. Garland Independent School Dist.*, 489 U. S. 782, 792 (1989); and *Rhodes v. Stewart*, 488 U. S. 1, 3-4 (1988) (per curiam).

nonadmission-of-liability clause can be interpreted to mean that as a matter of law the plaintiff was not a prevailing party. The court (prodded by counsel) can declare that the parties joint agreement that plaintiff is a “prevailing party” does not legally make it true, and the court’s decision on the law is otherwise.

§ 12.02 Settlement tactic for defendants; trap for plaintiff’s counsel

Some attorneys have gotten caught up in disputes with their clients and grievance committees because of the lawyer’s faulty understanding of “who owns the attorney fee award.”

Do attorney fees awarded to a prevailing party belong to the attorneys who labored to earn them or to their clients? The answer to that question is important in settlements. For example, if the attorney fee award is likely to be more than the attorney’s fee contract with the client provides, if the client “owns” the fee award, the client may benefit by waiving the attorney fee award as a condition of a comfortable settlement, or may want to keep the awarded attorney fee for herself. As another example of why that question is important, consider that the answer to that question of “ownership” of the fee award determines who must sign the settlement agreement as a party to the settlement contract.

In some few states, and in some few instances, — if the fee contract between attorney and client specifies that the attorney fee award will be the attorney’s fee due from the client, then it is held that the attorney fees awarded to a prevailing party belong to the attorneys, not to their clients, absent an agreement to the contrary.¹⁵¹ The theory of such fee ownership is that to increase public vindication of fundamental public policies attorneys need assurance that, if they obtain a favorable result for their client, they will actually receive reasonable attorney fees, instead of the sum a middle class or poor client is willing to pay to prosecute the matter.

However, in most states and under most federal statutes, and almost always in federal court, the reasoning is that where fees can be awarded to the “prevailing party,” the right to receive the attorney fee award belongs exclusively to that party and not to the party’s lawyer, thus allowing clients – not the lawyer – to bargain with the adversary about the attorney fees, including waiving statutory attorney fee awards.¹⁵²

Generally, the legal theory is that the right to seek and to receive an attorney fee is a cause of action (or part of it) that the client owns. Attorneys are ethically forbidden from

¹⁵¹ E.g., see *Flannery v. Prentice*, 26 Cal.4th 572, 28 P.3d 860, 110 Cal.Rptr.2d 809 (Cal. 08/13/2001).

¹⁵² E.g., see *Evans v. Jeff D.* 475 U.S. 717 (1986). Cf., *U.S. ex rel. Virani v. Jerry M. Lewis Truck Parts & Equipment* (9th Cir. 1996) 89 F.3d 574, 577, cert. den. (1997) 519 U.S. 1109. [Under the federal False Claims Act, a client’s “right” to reasonable attorney fees “is really a power to obtain fees for his attorney; the attorneys’ right does not come into being until the client exercises that power; the defendant’s liability will only arise if that power is exercised”].)

taking an assignment of the cause of action they are prosecuting for the client. That means, among other things, just as the client cannot assign his/her entire liability cause of action to the attorney, so too the attorney ethically cannot request the client to assign the right to recover the attorney fee to the attorney.

This fact of non-assignability of causes of action to the attorney for the client forms the base for a settlement tactic for defendants in cases involving fee-shifting states authorizing an attorney fee award to the prevailing party. Here's why. The norm in most civil rights, employment, and like cases is for the attorney to undertake the case on the basis of a contingent fee. Defendants in such cases can use the tactic of offering a lump-sum settlement that could benefit a plaintiff but not provide enough for their lawyer's time investment in the case. It's a tactic that works in small damages cases.

For example, suppose a case of racial discrimination in employment, that the claimant's attorney has the case on a 33% contingency fee contract, and has put in \$50,000 of time bringing the case up to the courthouse door. Suppose further that the main economic damage of the plaintiff is the payment of \$20,000 in lost wages until she found alternative better-paying employment. The defendant offers a total of \$60,000 for a total settlement "including any claim for attorney fees." To the plaintiff such a settlement sounds good: she gets \$60,000, deducts and pays her attorney \$20,000 in accord with the fee contract, and she winds up with \$40,000 for her \$20,000 in economic loss. But to the attorney, he winds up with \$20,000 in fees to pay for \$50,000 of time invested.

Alert defense counsel will always issue a demand for production of the plaintiff attorney's fee contract. If the fee award is a part of the issues, then the attorney-fee contract is a legitimate target of discovery. Once a contingent fee contract is found, the defense always should think in terms of a lump sum settlement "including any claim for attorney fees."

There are many civil rights and other cases that present legitimate claims by an individual where the plaintiff secures an attorney even though the case is a low-value case with little damages to be recovered for the injury. Attorneys seek various ways of protecting themselves, often by fee contract clauses that are not ethically proper or are otherwise unenforceable. For example, the lawyer in *Pony v. County of Los Angeles*¹⁵³ was working on such a case, and reasonably expected that the defendant would offer to settle for a small amount including the attorney fee award. To protect himself he devised a retainer agreement that transferred a plaintiff's right to seek fees to the attorney himself -- letting him sue for his fees even after his client settled. As happens in these cases with regularity, the U.S. Circuit Court of Appeals held the fee contract clause invalid.

The Supreme Court has held that Section 1988 vests the right to seek attorney's fees in the prevailing party, not her attorney, and that attorneys therefore lack standing to pursue them. [*citing numerous cases*] . . . Once the prevailing party exercises her right to receive fees, [assuming the fee contract gives the attorney the fee award] the attorney's right to collect the vests, and he may then pursue them on his own. Virani, 89 F.3d at 578. Unless and until the party exercises this

¹⁵³ 433 F.3d 1138 (9th Cir. 2006).

power, however, the attorney has no right to collect fees from the non-prevailing party, and the non-prevailing party has no duty to pay them. *Id.* A prevailing party may waive her statutory eligibility for attorney's fees as a condition of settlement. *Evans*, 475 U.S. at 737-38 (concluding that 42 U.S.C. § 1988 does not create a general rule prohibiting settlements conditioned on the waiver of fees).

In this case, Pony, the prevailing party, did not exercise her rights to pursue attorney's fees. To the contrary, she waived them as a condition of settlement with the County. Accordingly, under the Court's ruling in *Evans* and our ruling in *Virani*, Mitchell has no standing to pursue attorney's fees merely as a result of his position as Pony's former attorney.

Mitchell argues that he need not rely on his status as Pony's former attorney. He contends that he has standing under his retainer agreement with Pony, whereby she assigned her rights to apply for attorney's fees to him. If the assignment is valid, Mitchell argues, he stands in her shoes and may assert her rights to statutory attorney's fees as if she had asserted them herself. However, Pony's putative assignment to Mitchell is invalid because the right to seek attorney's fees under 42 U.S.C. § 1988 is a substantive cause of action which cannot be transferred contractually.

Pony v. County of Los Angeles, 433 F.3d 1138 (9th Cir. 2006).

§ 12.03 Tax problem in settlements

It is common for parties to settle a case after a verdict. Clients of the prevailing party normally will assume the award of attorney's fees goes to the attorney and hence the attorney fee is not income to be reported to, or taxed by, the IRS. Clients may make the same assumption if the settlement agreement provides for payment of an attorney fee directly to the attorneys. The clients' assumption is wrong. To prevent later claims of legal malpractice in the attorney's advice regarding settlement, the attorneys for the prevailing party should keep in mind that the client's normal expectation may be wrong.

The Internal Revenue Department takes the position that the award of the attorney fee is owned by the party, not her attorney, and taxes the full award received by the party, including the attorney fee, even if the fee is paid directly to the attorney. In cases where attorney fees exceed the damage awards -- such as in public interest litigation where relief is injunctive or awards are minimal -- a client could be forced to pay more in taxes than he or she won in the award.

In the case of a litigation recovery the income-generating asset is the cause of action derived from the plaintiff's legal injury. The plaintiff retains dominion over this asset throughout the litigation. . . . When a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee.

Commissioner of Internal Revenue v. Banks, 125 S.Ct. 826, 543 U.S. 426, 160 L.Ed.2d 859 (U.S. 01/24/2005).¹⁵⁴

(After the client has paid the IRS, then the IRS gets a second bite of the apple by taxing the income received by the attorney!)

¹⁵⁴ The fees in the *Banks* case were calculated on the basis of the attorney fee contract. There is still a small ray of hope for taxpayers who received statutory attorney fee awards prior to the effective date of the new legislation. The court specifically left open the issue of how statutory attorney fees should be treated. But it is a dim small ray of hope.