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Hot-Button Settlement Issues

by

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A. Sticking Points in Mediation Agreements

As a mediator, I have often found that the easy part of the mediation is resolving the specific relief for the employee. The hard part is resolving the often overweening demands of employers for every clause they have ever seen featured on the long-running reality show, "Really Oppressive Conditions to Foist on Anyone Who Dares Settle With Me."

Because counsel for the employer often drafted the oppressive terms without any pushback from anyone, it can be difficult for them to admit they may have gone just a teensy bit overboard, and to agree to more sensible wording.

Counsel for the employee need to fight oppressive terms, in order to avoid problems down the line for their clients. They cannot, however, have a "policy" of refusing to accept particular terms, because their clients have the right to settle their cases on the terms they are willing to accept. Counsel can and must recommend that their clients reject oppressive terms and explain the adverse consequences of the terms to their clients, but must accept and implement the clients' decisions or withdraw from the representation.

Counsel for employees are well advised to put their advice and warnings in writing before their clients decide to accept particular terms.

1. Confidential Information

Definitions of confidential information, with a prohibition on sharing such information with third parties, are an important part of a settlement and a useful reminder to the employee that trade secrets, information on business plans, inside financial information, and the like must not be shared with others. Properly drafted, such clauses will identify the categories of sensitive information and make it easier for the employer to claim a breach when there has been one, and for the former employee to defend his or he conduct when he or she is innocent.

However, it is common for employers to insist on declaring confidential so much information, defined so loosely, that the employer's name and stock price would be covered. That is unwise for employers, since a badly over-inclusive definition of confidential information risks the enforceability of the clause and tends to justify a former employee's claim of confusion and therefore innocence.

Counsel for employees should insist on trimming back the definition, and at least on language stating that any information in the public domain, or previously released by the employer to the public, will not be within the definition of confidential information.

2. Confidentiality of the Settlement

Employers routinely insist that both the existence of a settlement and its terms be confidential. It is certainly understandable that an employer will not want to hoist a flag and invite every past and present employee with a grievance to think similar terms are available on demand.

The language of employers' proposed confidentiality clauses often needs changes:

- Employees should insist on the right to tell their spouses of the settlement and the financial details; spouses may have a right to share in the proceeds in community-property States, and may be signing the tax returns.

- Tax authorities may ask for details, and the employee needs to be able to comply, so there needs to be specific permission to inform tax authorities if needed.

- Third parties may have rights of recoupment and there may be statutory or contractual duties to inform them of the financial details. Unemployment compensation funds, welfare agencies, and insurance companies may be among this group. The failure to inform the proper authorities of the financial details may expose the employee to criminal prosecution. If an employee has a duty to inform third parties, counsel need to make clear in the agreement that doing so is not a violation.

- It is in the interest of both sides that speculation be laid to rest. Each side should be able to respond to inquiries by saying the matter has been resolved confidentially. —

In addition, employees also have an interest in confidentiality. There is no point in leaving the employer free to tell all and sundry—including prospective employers checking references on the employee—that the employee made a discrimination or retaliation or harassment complaint, that the employer thought it was baseless, and that it was settled out of court.

3. Right to Share Nonfinancial Settlement Terms With Other Employees Under the NLRA

Secs. 7 and 8(a)(1) of the National Labor Relations Act, 29 U.S.C. §§ 157 and 158(a)(1) state:

> Sec. 7. Employees shall have the right . . . to engage in other concerted activities for the purpose of . . . mutual aid or protection . . . .
>
> UNFAIR LABOR PRACTICES
>
> Sec. 8. (a) [Unfair labor practices by employer] It shall be an unfair labor practice for an employer—
>
> (1) to interfere with, restrain, or coerce employees in the exercise of the rights guaranteed in section 7 [section 157 of this title];
>
> * * *

The statutory language does not require that the employee be in a union.

If the settlement involves a current employee, the National Labor Relations Board may take the position that the employee is entitled to share nonfinancial information about the settlement with other employees. For example, in *Ducci Electrical Contractors and William Juliano, An Individual*, 2011 WL 3228130 (N.L.R.B. ALJ Decision, Feb. 15, 2011), the Administrative Law Judge held that the employer committed an unfair labor practice by threatening to sue an employee for disclosing a settlement in violation of a confidentiality clause. The ALJ stated:

> The Agreement's terms that he is prohibited from revealing include that Respondent denies acting wrongfully; Juliano agrees to withdraw the charge with prejudice and not bring any action against the Respondent relating to its decision not to hire him; his agreement to accept $1,200; a release of all claims in connection with his employment and the Respondent's decision not to hire him; the parties agree not to disparage each other; and the parties acknowledge that the Employer is a party to a contract with Local 35, IBEW, pursuant to which it retains the right to reject applicants referred to it by the Union.
>
> The February 26 letter, by its terms, constitutes a threat to sue Juliano for breaching the confidentiality provision of the settlement agreement which prohibits Juliano from speaking about the terms of the settlement. Those terms include statements about Juliano's filing of the charge which alleges that the Employer committed an unfair labor practice in deciding not to hire him, and the application of the Respondent's collective-bargaining agreement with the Union.
>
> The Respondent correctly argues that the Regional Office was aware of the confidentiality provision and approved Juliano's request to withdraw his charge based on it.[3]
>
> By its terms, the confidentiality provision prohibits Juliano from revealing the terms of the settlement agreement to anyone, including his Union, which has a material interest in being informed about how employees' grievances and charges are disposed of. Further, the Union, in representing Juliano or another employee may seek to use the facts in the settlement agreement as background for any further grievance which may be filed. In addition, Juliano should be able to speak to co-workers about the non-financial terms of the settlement agreement as part of the exercise of his Section 7 rights to communicate with other employees about their terms and conditions of employment.
>
> I accordingly find that the Respondent's February 26 threat to sue Juliano for disclosing the non-financial terms of the settlement agreement constitutes an independent violation of Section 8(a)(1) of the Act.

The only way to enforce rights under the NLRA is to file an unfair labor practice charge with the National Labor Relations Board within the six-month period of limitations. The NLRB's General Counsel will decide whether to prosecute it, and is in control of the prosecution. If not settled, the matter is tried before an Administrative Law Judge, whose findings can be appealed to the Commission. The remedies can include reinstatement, removal of discipline, back pay, and remedial notices.

Unlike the EEOC, the NLRB has noticed developments over the past forty years, makes charge forms available on-line, and allows electronic filing of charges. See http://www.nlrb.gov/resources/forms for copies of the charge forms against various entities, and https://apps.nlrb.gov/eservice/efileterm.aspx?app=chargeandpetition for charge-filing.

The EEOC should take notice.

4. Liquidated Damages for Breach of Confidentiality

Employers frequently put clauses in draft settlement agreements requiring the employee to pat liquidated damages in the event of any breach of confidentiality. The specified penalty is often the entire consideration paid by the employer.

In every case, but particularly in cases involving retaliation, I recommend that my clients not accept such a term unless it is mutual. I do not want to tempt the worse sides of employers' natures by making them think my client is a piggy bank they can tap whenever cash flow dips.

News of a settlement can get out because someone in management is loose-lipped, or because support staff is loose-lipped, or because someone in the defense law firm is loose-lipped. It is only fair that there be a remedy for their indiscretions, and the appropriate remedy would probably be a doubling of the original consideration.

In every settlement, both sides are taking a risk that the existence or terms of a settlement will come out, and both need to recognize that finding out who was responsible may be difficult. A one-sided liquidated-damages provision simply encourages the employer to assume the employee is responsible for any breach. Demanding mutuality of liquidated damages is an effective tool for making the employer realize there can be no easy assumptions of responsibility.

Interestingly, once the employer starts to realize there are nuances, its interest in liquidated damages often disappears.

B. Effect of Failure to Manage Parties' Expectations

When representing either side in an employment dispute, it is important that our clients be regularly doused with buckets of the cold water of reality. Our clients see and approve the demand letters and responses we send, and there is an ever-present risk of their confusing the persuasiveness of our writings as an indication of objective truth and the absence of any problems.

In every individual representation, I routinely send my clients written reminders of all the risks we face, to make sure they have a realistic understanding of their situations so they can make informed decisions. Settlement is much easier when expectations have been managed.

This is not a universal approach, however. I've been contacted numerous times by employees whose claims have justly failed, and who were never informed by their prior counsel that there were any potential problems with their claims. It is difficult for claims to be settled on a reasonable basis when the employee—and sometimes counsel for the employee—have no idea

of factors legitimately reducing the value of their claims. When defense counsel are faced with such a situation, the best remedy is probably mediation with someone the plaintiff and plaintiff's counsel will feel they need to listen to, such as a well-regarded former judge, or a well-respected plaintiff's lawyer.

Similar situations arise on the defense side. When acting as a mediator, I am sometimes told by defense counsel that they need me to deliver bad news to their clients. It may be because the client is headstrong and has stopped listening to its own counsel. In cases involving municipal governments, it may be because the faction making the decisions refuses as a matter of principle to listen to counsel because counsel was chosen by another faction with which it is at odds. It may be because, as defense counsel explained to me, he feared being replaced if he delivered the bad news himself.

Whether it is the employer or an employee that is being unrealistic, the flawed perception may make settlement impossible, and the result of litigation may be an unpleasant surprise.

C. <u>Scope and Effect of Releases</u>

Employers generally want releases that cover everything—not just matters relating to employment—from the beginning of the universe to the date the release is signed, and that cover all their officers, Board members, officials, and employees. Sometimes, they even want to include suppliers.

There cannot be a prospective waiver of rights under the employment discrimination laws. *Alexander v. Gardner-Denver Co.*, 415 U.S. 36, 50 (1974), stated: "To begin, we think it clear that there can be no prospective waiver of an employee's rights under Title VII."

If an employee was struck by a car in a hit-and-run accident, and a year later signs such a release in order to resolve an employment claim, and subsequently learns that the hit-and-run driver was a Director or supplier of the employer, does anyone think the release would be effective as to the hit-and-run tort?

What if the employee was induced to sign the release by a deliberately false description of what it contained? Does anyone think that would be effective? In *Dice v. Akron, C. & Y. R. Co.*, 342 U.S. 359, 362 (1952), applying Federal law in a Federal Employers' Liability Act case, the Court rejected the holding of the Ohio Supreme Court that a release fraudulently obtained binds the plaintiff because he or she was negligent in relying on the employer's statements:

> Second. In effect the Supreme Court of Ohio held that an employee trusts his employer at his peril, and that the negligence of an innocent worker is sufficient to enable his employer to benefit by its deliberate fraud. Application of so harsh a rule to defeat a railroad employee's claim is wholly incongruous with the general policy of the Act to give railroad employees a right to recover just compensation for injuries negligently inflicted by their employers. And this Ohio rule is out of harmony with modern judicial and legislative practice to relieve injured persons from the effect of releases fraudulently obtained. . . . We hold that the correct federal rule is that announced by the Court of

> Appeals of Summit County, Ohio, and the dissenting judge in the Ohio Supreme Court—a release of rights under the Act is void when the employee is induced to sign it by the deliberately false and material statements of the railroad's authorized representatives made to deceive the employee as to the contents of the release. The trial court's charge to the jury correctly stated this rule of law.

(Citations omitted.)

Employers seeking effective releases of ADEA claims must comply with the requirements of § 201 of the Older Workers' Benefits Protection Act, amending § 7 of the ADEA and setting minimum requirements for releases to be considered knowing and voluntary. *Oubre v. Entergy Operations, Inc.*, 522 U.S. 422 (1998), held that releases are not effective as to ADEA claims if they do not meet these standards, although they may still be effective as to other claims. The Court also held that a plaintiff did not need to return the consideration for the release as a precondition to filing suit. The Court stated at 428:

> In further proceedings in this or other cases, courts may need to inquire whether the employer has claims for restitution, recoupment, or setoff against the employee, and these questions may be complex where a release is effective as to some claims but not as to ADEA claims. We need not decide those issues here, however. It suffices to hold that the release cannot bar the ADEA claim because it does not conform to the statute. Nor did the employee's mere retention of moneys amount to a ratification equivalent to a valid release of her ADEA claims, since the retention did not comply with the OWBPA any more than the original release did. The statute governs the effect of the release on ADEA claims, and the employer cannot invoke the employee's failure to tender back as a way of excusing its own failure to comply.

There is still a legal question whether releases of all claims must be knowing and voluntary. *See*, *e.g.*, *Russell v. Harman Int'l Industries, Inc.*, 773 F.3d 253, 255-56 (D.C.Cir. 2014) (reserving the question as to Title VII claims, since the parties agreed on this point):

> Russell complains that the district court did not afford him discovery on whether he knowingly and voluntarily consented to the severance agreement. We generally require waivers of liability to be "knowing and voluntary" in the context of Title VII. . . . Most of our sister circuits have extended the knowing-and-voluntary requirement to the ERISA context as well. . . . . Our precedent is unclear. We see no reason to take a position in this case because the parties agree that the knowing-and-voluntary standard applies.

(Citations omitted.) However, most Circuits use the "knowing and voluntary" standard. *E.g.*, *Lawson v. J.C. Penney Corp., Inc.*, 580 Fed.Appx. 492, 493-94, 2014 Fair Empl.Prac.Cas. (BNA) 170 (7th Cir. 2014) (collecting cases).

Many employers follow the OWBPA requirements even for employees too young to be covered by the ADEA, because meeting them comes very close, in most cases, to establishing that the resulting release was knowing and voluntary.

Employers risk making their releases ineffective when they go too far.

D. Buyer's Remorse, Duress, and Unconscionability

Employees who regret signing releases often argue that they were coerced into signing, and that their releases were therefore invalid. They face a steeply uphill climb to succeed.

The First Circuit's decision in *Cabán Hernandez v. Philip Morris USA, Inc.*, 486 F.3d 1, 10-11, 100 Fair Empl.Prac.Cas. (BNA) 738 (1st Cir. 2007), is typical:

> The appellants have a fallback position. They asseverate that, notwithstanding the persuasive force of the Smart factors, a finding that they acted knowingly and voluntarily is precluded (or, at least, called into legitimate question) because they were coerced into signing the releases. In this regard, they complain that each of them "felt [he] had no other alternative but to sign the agreement and general release" due to the "pressure, rage, indignation, depression, demoralization and confused mental state [caused] by the hostile, discriminatory work environment" created by Philip Morris. . . . To drive this point home, the appellants attempt to draw an analogy to situations in which an employer has made working conditions so unsavory that options given to employees become "nothing more than a charade." . . . .
>
> These importunings comprise more cry than wool. The cases that the appellants cite to support their claim of coercion are, without exception, constructive discharge cases. In those instances, the employees claimed that they were choosing between further service under intolerable working conditions and resignation. . . . Here, however, there was no such Hobson's choice: the appellants already had been told of their impending loss of employment at the time they opted to waive their rights. Their choice was either to sign the proffered releases and receive extra benefits or to pursue legal action over the loss of their jobs. Either way, they would no longer be subject to the hostile work environment that they claim flourished at Philip Morris. So viewed, that hostile work environment, even if it existed, could not have played a legally significant role in the appellants' decisions to sign the proffered releases.

(Citations and footnote omitted.)

In *Batjer v. AHS Hosp. Corp.*, 594 Fed.Appx. 73 (3d Cir. 2014) (*per curiam*), for example, the *pro se* plaintiff argued that her release was invalid because the employer threatened it would block her unemployment benefits unless she signed the release. The court rejected her argument:

> In her complaint, Batjer stated that AHS forced her to sign the waiver by threatening to block her unemployment benefits if she failed to do so. Waivers signed under duress may be ineffective. *See generally,* 25 Am.Jur. 2d Duress and Undue Influence § 26 (2014). However, at the hearing before the District Court, Batjer explained that she signed the release simply so she could move on with her life. In light of Batjer's statement, the District Court concluded that the release was signed knowingly and

> voluntarily. That conclusion is bolstered by the fact that Batjer waited over two weeks before she signed the agreement, during which time she consulted two attorneys.

Lawson v. J.C. Penney Corp., Inc., 580 Fed.Appx. 492, 494, 2014 Fair Empl.Prac.Cas. (BNA) 170 (7th Cir. 2014), rejected the plaintiff's assertions that her release was not knowing and voluntary, in light of her education and training, and in light of the time she had to consider it before signing:

> The undisputed facts show that Lawson knowingly and voluntarily released any right she had to bring this lawsuit. Lawson is college educated and has worked in positions requiring her to read technical materials. . . . *See Hampton*, 561 F.3d at 717 (reasoning that high school diploma and some college and paralegal courses supported finding waiver voluntary and knowing). The waiver prominently stated that Lawson was giving up any right to sue J.C. Penney for discrimination under any law, including Title VII and the Equal Pay Act, and that she understood this. It granted her 45 days to consider the release and consult an attorney, ample time under the law. *Compare id.* at 717 (ruling that six weeks was "ample time" to consider buyout offer) *with Pierce v. Atchison, Topeka & Santa Fe Ry. Co.*, 110 F.3d 431, 440 (7th Cir.1997) (ruling that, by giving employee only one business day to consider severance package, employer created "inordinate time pressure"). Finally, in exchange for releasing her claims, Lawson received about 15% of her annual salary—money that she was not otherwise entitled to. We recognize that Lawson did not negotiate the terms of the release. That factor, however, is outweighed by the factors otherwise showing substantive and procedural reasonableness in the exchange. *See Hampton*, 561 F.3d at 717. We therefore conclude that, on the undisputed record, Lawson knowingly and voluntarily waived her right to file these claims.

McDermott v. City of North Olmsted, 178 Fed.Appx. 515 (6th Cir. 2006), held that a release was valid and enforceable, rejecting a claim that the employee had not been given enough time to consider the agreement. The employer had spent six weeks negotiating the terms of a severance, and had exchanged three drafts with employee. The employee was highly-educated, a civil engineer. The court rejected the employee's claim the employer denied him reasonable time to consider the agreement by demanding, at the end of the process, that he sign the agreement that day or it would be withdrawn.

E. Tender-Back Requirements

The Seventh Circuit has held that tender-back requirements are enforceable as to non-ADEA claims:

> In any event, summary judgment was correct because Lawson ignored the tender-back requirement. At no time has Lawson offered to return to J.C. Penney the severance payment that she received from it in exchange for releasing the claims on which she now sues. Because her claims fall within the scope of the waiver, she cannot sue without first seeking to rescind the release. *Hampton*, 561 F.3d at 717. And rescission requires that Lawson tender to J.C. Penney the consideration that she received. *Id.*; *Fleming v. U.S. Postal Service AMF O'Hare*, 27 F.3d 259, 260–61 (7th Cir.1994). Without that tender,

> she cannot attempt to undo her release and sue. *Hampton*, 561 F.3d at 717. Moreover, no exception to the tender requirement applies here: Neither party is alleging fraud, Lawson received adequate consideration, and no statute abrogates the tender-back requirement for releases of claims under Title VII and the Equal Pay Act. *See Fleming*, 27 F.3d at 261–62. Therefore, the district cour t's grant of summary judgment was correct for this additional reason.

Lawson v. J.C. Penney Corp., Inc., 580 Fed.Appx. 492, 494, 2014 Fair Empl.Prac.Cas. (BNA) 170 (7th Cir. 2014).

Even if the employee does tender back the consideration for the release, the employee may still be bound by the release.

F. <u>Effect of Inconsistent Terms on Validity of Releases</u>

Syverson v. International Business Machines Corp., 472 F.3d 1072 (9th Cir. 2007), reversed the grant of summary judgment to the ADEA collective action defendant and held that IBM's release and covenant not to sue did not meet the requirement of the OWBPA. The flaw in question was that IBM's severance package required that employees sign a document containing a release of all claims, including ADEA claims, and also containing a covenant not to sue that expressly excluded claims under the ADEA. Judge Berzon summarized the panel ruling at 1073:

> Under the Older Workers Benefit Protection Act ("OWBPA"), employees may not waive rights or claims arising under the Age Discrimination in Employment Act ("ADEA") unless the waiver is "knowing and voluntary." 29 U.S.C. § 626(f)(1) (2000). To qualify as "knowing and voluntary," a waiver included in an agreement between an employer and its employees must, among other things, be "written in a manner calculated to be understood" by the average employee eligible to participate in the agreement. Id. § 626(f)(1)(A). This appeal presents the question whether a waiver form used by International Business Machines Corp. ("IBM") in connection with a severance benefit package meets that standard. We hold that it does not and was therefore not "knowing and voluntary." *Id.* § 626(f)(1).

The court further elaborated on the OWBPA requirements in referring with approval to the U.S. Department of Labor's explication:

> To satisfy the "manner calculated" requirement, "[w]aiver agreements must be drafted in plain language geared to the level of understanding of the individual party to the agreement or individuals eligible to participate" in a group termination plan. 29 C.F.R. § 1625.22(b)(3) (2005). Employers are thus instructed to "take into account such factors as the level of comprehension and education of typical participants." *Id.* These considerations "usually will" require the limitation or elimination of technical jargon and of long, complex sentences." *Id.*

Id. at 1076 (footnote omitted.) Because the court held that the basic requirements of the statute were not met, it saw no reason to decide whether to adopt the "totality of the circumstances" approach for deciding matters as to which the basic requirements are met. *Id.* at 1077 n.7. The

court held that the apparent conflict between the release and the covenant not to sue would be confusing to the ordinary reader, and that IBM's business purpose in adding the covenant not to sue—to ensure its ability to collect damages if a signing employee sued on a waived claim—did not save the provision:

> Given this substantive overlap between releases and covenants not to sue, that fact that the MERA Agreement's covenant not to sue contains an exception for ADEA claims necessarily creates potential confusion, as it appears to lift any barrier from proceeding to court with an ADEA claim. The confusion ensues, in part, from including in a single document two concepts that, technically speaking, cannot coexist. Under the classic definitions contained in Black's Law Dictionary and in the case law quoted above, a covenant not to sue is pertinent only if the underlying right is not extinguished, while a release extinguishes any underlying right. Where both nonetheless appear in the same document, the covenant not to sue largely swallows the release—and the negation of the covenant not to sue can therefore be read as negating the release as well.
>
> IBM stresses that without the covenant not to sue it would have been deprived of the "full benefit of its bargain" with those employees who signed on to the MERA Agreement, because without the covenant, although "IBM could raise the Release as an affirmative defense and obtain a dismissal of the suit, it still would be out its costs and attorneys' fees." IBM also maintains that the covenant not to sue was drafted to comply with the EEOC regulation that provides: "[n]o ADEA waiver agreement, covenant not to sue, or other equivalent arrangement may impose any . . . penalty, or any other limitation adversely affecting any individual's right to challenge the agreement . . . . [including] provisions allowing employers to recover attorneys' fees and/or damages because of the filing of an ADEA suit." 29 C.F.R. § 1625.23(b).
>
> It very well may have been IBM's intention to draft an agreement that would preserve the right of an employee to challenge without penalty his waiver of ADEA claims as not knowing or voluntary. *See Thomforde II*, 406 F.3d at 504 (observing that "[t]he intended effect of the Agreement was to release the employee's substantive claims under the ADEA, while preserving the employee's right to challenge the validity of the release through a lawsuit, as provided by the regulations" (citing 29 C.F.R. § 1625.23(b))). If that was IBM's intention, it would have been quite easy to have accomplished this purpose directly. The MERA Agreement, by contrast, uses a term unfamiliar to lay people,"covenant not to sue," and does not explain how the release and the covenant not to sue dovetail, either in general or as they relate to the ADEA claims. *See id.* (noting that "the Agreement does not explain how the provisions relate to each other or the limited nature of the exception to the covenant not to sue in light of the release of claims"); *see also* 29 C.F.R. § 1625.22(b)(3) ("Consideration [of the need to draft waiver agreements in plain language] . . . usually will require the limitation or elimination of technical jargon and of long, complex sentences.").
>
> Indeed, far from explaining the intended, independent functions of the release and of the covenant not to sue, the MERA Agreement muddles the matter by referring to both provisions with the same shorthand name—"Release"—indicating interchangeability, not distinction. *See Thomforde II*, 406 F.3d at 504 (noting same). Adding to the confusion,

> the paragraph containing the covenant not to sue in fact refers to the covenant and the broader "Release" as if the terms were completely interchangeable. *See id.* (noting same).

Id. at 1085.

Thomforde v. International Business Machines Corp., 406 F.3d 500, 95 FEP Cases 1145 (8th Cir. 2005), also held that these aspects of IBM's release and covenant not to sue were too confusing to meet the OWBPA requirements.

G. No-Reapplication Clauses in Severance and Settlement Agreements

Employers frequently insist, as a condition of settlement or in severance agreements, that the former employee never re-apply to work with the employer. Alternatively, the employer may insist on an acknowledgment by the former employee that he or she is no longer eligible for rehire.

From the employer's perspective, in the absence of such an agreement it will be forced to rehire a plaintiff or claimant or face an expensive retaliation claim, and everything thereafter may morph into a retaliation claim.

From the employee's perspective, none of the EEO laws require a person to resign whenever he or she resolves an EEO claim of engages in protected activity. To the contrary, the aim of the EEO laws is to keep the affected employees in the workplace, so that future claimants will not be deterred.

Both sides are probably able to recognize that such conditions may make it more difficult for the former employee to obtain another job. It is always preferable to be able to say truthfully to a prospective employer that one is eligible to return. When I have been asked for my reference with respect to a former employee of my firm, I am routinely asked if the former employee is eligible for rehire. It's a natural question to ask, and one can appreciate the bite if the answer were negative.

1. Job Segregation

Where there is a pattern of job segregation in violation of Title VII, no-rehire and no-transfer policies are unlawful barriers to a nondiscriminatory workforce. *Hairston v. McLean Trucking Co.*, 520 F.2d 226, 231-32 (**4th Cir.** 1975), rejected such policies when used to try to limit back pay:

> The no-transfer policy meant that blacks were denied promotion out of the low-paying departments to which they were initially assigned. The no-rehire policy meant that a black could not resign and seek to be rehired into a better job, even if the employee were willing to assume the risk of reemployment and forfeiture of seniority. Moreover, vacancies were not posted; thus the plaintiffs were ordinarily denied even the knowledge necessary to make the futile gesture. . . . and there is evidence that when some of the plaintiffs expressed concern about the dead-end nature of their jobs, they were told that they could leave if they did not like it.

> To accept these barriers to promotion and transfer as a rationale for denying back pay would, in our view, manifestly frustrate the "broad objectives" of Title VII. If an employer can avoid back pay liability through a policy which makes an attempt to gain a better job risky or futile, then this subtle form of discrimination is encouraged, not discouraged. Similarly, plaintiffs harmed by such policies plaintiffs deterred by the futility or risk of seeking promotion are denied an award which would "make them whole," not because they were not disadvantaged by discrimination, but merely because of the peculiar method by which discrimination was implemented.

2. **Retaliation Claims**

If the employer does not have a general policy but insists on such conditions only as to former employees who engaged in protected activity, it is easy to see a retaliation claim.

Is a retaliation claim available, however, when there is a general policy applicable to all former employees, without regard to whether they ever engaged in protected activity? The Supreme Court has answered this question negatively.

Raytheon Co. v. Hernandez, 540 **U.S.** 44 (2003), involved a long-time employee terminated for violating workplace conduct rules by acting strangely at work and admitting the use of cocaine and alcohol. He re-applied two years later, and the defendant urged that he was rejected because of an unwritten policy barring the re-employment of persons who had been discharged for misconduct, or resigned in lieu of such discharge. He waived any disparate-impact claim by failing to raise it timely. Writing for a unanimous seven-member Court, Justice Thomas stated: "Had the Court of Appeals correctly applied the disparate-treatment framework, it would have been obliged to conclude that a neutral no-rehire policy is, by definition, a legitimate, nondiscriminatory reason under the ADA." *Id.* at 51-52 (footnote omitted). The Court also stated at 53:

> Petitioner's proffer of its neutral no-rehire policy plainly satisfied its obligation under *McDonnell Douglas* to provide a legitimate, nondiscriminatory reason for refusing to rehire respondent. Thus, the only relevant question before the Court of Appeals, after petitioner presented a neutral explanation for its decision not to rehire respondent, was whether there was sufficient evidence from which a jury could conclude that petitioner did make its employment decision based on respondent's status as disabled despite petitioner's proffered explanation. . . .

Finally, the Court held at 55: "If petitioner did indeed apply a neutral, generally applicable no-rehire policy in rejecting respondent's application, petitioner's decision not to rehire respondent can, in no way, be said to have been motivated by respondent's disability."

3. **Effect on Back Pay Claims**

Suppose that an employee subject to a general policy has made a claim of termination in retaliation for engaging in protected activity of some kind. And make the further reasonable assumption that this has hindered the employee in obtaining a replacement job. If the employee can prove the hindrance, the employee may be have a stronger defense to any claim of failure to

mitigate, and may be entitled to front pay for a longer period, as a remedy for the additional harm caused by the policy. An analogy may be useful.

Taylor v. Republic Services, Inc., 968 F.Supp.2d 768, 801 (E.D.Va. 2013) (Lee, J.), awarded $377,734 in back pay and $804,791 in front pay, as well as $50,000 in compensatory damages, to the Title VII retaliatory discharge plaintiff in a bench trial. The court held that defendant's noncompete agreement enhanced the damages:

> The Court finds that Ms. Taylor is entitled to be made whole due to Republic Inc.'s unlawful retaliatory discharge. The evidence at trial demonstrates that Ms. Taylor made reasonable efforts to mitigate her damages. Due to Ms. Taylor's non-compete agreement, she was precluded from applying for positions in the field in which she had gained a great deal of experience. Ms. Taylor testified that applied for more than one-hundred (100) positions, but she only received one job offer.

The earnings difference is illustrated by plaintiff's expert's calculation—adopted by the court—that she would have made $272,248 in calendar year 2012 if she had remained employed with defendant, compared to the $46,347 she actually made in her replacement job outside the field for which was trained and experienced.

H. Practical Problems with Benefits

Under the Affordable Care Act, individuals who do not have insurance may be required to pay a penalty. Sometimes, however, individuals may have coverage through their employer, lose the coverage when their employment ends, and there may not be an open enrollment period in a qualified health plan either when their job ends or, for those entitled to COBRA benefits, when their period of COBRA benefits expires.

On May 2, 2014, the U.S. Department of Health and Human Services issued a guidance making clear that individuals eligible for COBRA are entitled to enroll in a qualified health plan in a Federally-facilitated marketplace in two special enrollment periods: "when: (1) such persons initially are eligible for COBRA due to a loss of other minimum essential coverage; and (2) when such persons' COBRA coverage is exhausted." This is in addition to the regular enrollment periods and any other special enrollment periods to which they may be entitled. Thus, these individuals may choose either to exercise their COBRA rights or enroll in a Federally-facilitated marketplace qualified health plan, confident that they will not be endangering their right to enroll in a Federally-facilitated marketplace qualified health plan when their COBRA coverage runs out. The Guidance refers to 45 C.F.R. § 155.420(d)(1).

The Guidance can be downloaded from http://www.dol.gov/cgi-bin/leave-dol.asp?exiturl=http://www.cms.gov/CCIIO/Resources/Regulations-and-Guidance/Downloads/SEP-and-hardship-FAQ-5-1-2014.pdf&exittitle=HHS_Bulletin&fedpage=yes.

The same rules do not necessarily apply to State Exchanges, but HHS has asked them to adopt similar rules.

I. Recurring Tax Questions in Employment Settlements and Litigation[1]

1. I sued the union as well as the employer for my client's loss of a promotion, and the union is paying part of the back pay award. That cannot be wages, because the union is not my employer. Is that part of the award taxable?

Yes. It is taxable as income. IRS Publication 525 (2013)[2] states

> To determine if settlement amounts you receive by compromise or judgment must be included in your income, you must consider the item that the settlement replaces. The character of the income as ordinary income or capital gain depends on the nature of the underlying claim. Include the following as ordinary income.
>
> * * *
>
> 2. Compensation for lost wages or lost profits in most cases.
>
> * * *
>
> 6. Back pay and damages for emotional distress received to satisfy a claim under Title VII of the Civil Rights Act of 1964.

2. Is back pay for an unlawful failure to hire or termination, where the plaintiff was not actually performing services for the employer, still taxable?

Probably. The IRS Lawsuits, Awards, and Settlements Audit Techniques Guide (May 2011), which comes with a hefty disclaimer,[3] states:

> Back pay paid to an employee or former employee by an employer in a settlement related to a claim under a workers' right statute or civil rights statute for a period during which no services were performed by the employee is also wages for federal employment tax purposes. Typically, back pay is awarded if an employee is illegally terminated by an employer, and, under those circumstances, the back pay relates to a period when no services for the employer were performed by the employee because of the illegal termination. The position that back pay is wages even though it is attributable to a period during which actual services were not performed is based on the Supreme Court's

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[1] Disclaimer: I am not a tax attorney, and this paper does not constitute tax advice for any purpose under the Internal Revenue Code. Readers with situations arising in the subject areas covered by this paper should retain their own qualified tax counsel or Certified Public Accountant.

[2] Note: Paragraph indentations are added to all quotations from Federal government publications, because the government is mistaken when it considers itself exempt from the requirements of literacy in English.

[3] NOTE: This document is not an official pronouncement of the law or the position of the Service and cannot be used, cited, or relied upon as such. This guide is current through the publication date. Since changes may have occurred after the publication date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the publication date.

holding in *Social Security Board v. Nierotko,* 327 U.S. 358 (1946), in which back pay awarded to an illegally terminated employee under the Fair Labor Standards Act (FLSA) was held to be wages for social security benefit purposes.

Nierotko has been applied in determining that wages for federal employment tax purposes includes back pay paid under a number of different workers' rights and civil rights statutes (for example, the Back Pay Act, the Age Discrimination in Employment Act (ADEA), and Title VII of the Civil Rights Act of 1964, and various state and local discrimination statutes). *See Tanaka v. Department of Navy,* 788 F.2d 1552, 1553 (Fed. Cir. 1986); *see also Blim v. Western Electric Co.,* 731 F.2d 1473, 1480 n. 2 (10th Cir. 1980); *but see Churchill v. Star Enterprises,* 3 F. Supp. 2d 622, 624-25 (E.D. Pa. 1998). The Court in *Churchill* held that an employer could not withhold FICA or income taxes from damages awarded for a violation of the Family and Medical Leave Act of 1993, 29 U.S.C.A. section 2601 *et seq. ("FMLA")*, because the employee was not performing services for the employer during the period for which the damages were awarded. *Churchill,* 3 F. Supp. at 624. The Court also stated that even if the wages were subject to withholding, the jury verdict did not distinguish between "an amount equal to any denied or lost wages" and "an amount equal to any denied or lost employment benefits," both of which are available damages under the FMLA. *Id.* Accordingly, the court could not determine if withholding was required.

However, the IRS Chief Counsel Memorandum, Release Number 20133501F, released August 30, 2013, which also comes with a disclaimer,[4] distinguished between the views of the IRS and the disagreeing views of some courts:

The Service's position is that payments constituting . . . back pay FN3 . . . are wages for employment tax purposes.

FN3 Note that there is some disagreement among the Federal appellate circuits on the character of back pay in an illegal refusal to hire claim. *Compare, e.g., Melani v. Board of Higher Ed.*, 652 F. Supp. 43 (S.D.N.Y. 1986), *aff'd* 814 F.2d 653 (2d Cir. 1987) (citing with approval Rev. Rul. 78-176, 1978-1 C.B. 303, which holds that back pay for discrimination in refusal to hire is wages for employment tax purposes) *with Newhouse v. McCormick & Co.*, 157 F.3d 582 (8th Cir. 1998).

3. **Is front pay taxable?**

Probably. The IRS Lawsuits, Awards, and Settlements Audit Techniques Guide (May 2011), states that front pay is "wages" subject to both income tax withholding and F.I.C.A. and Medicare deductions:

Service's [sic] position is that "front pay", which is pay awarded to the employee for future services (that is, generally service from the date of the settlement going forward) the employee would have performed but for the illegal actions of the employer,

[4] "This memorandum responds to your request for advice dated September 18, 2012. This advice may not be used or cited as precedent in other cases."

> is also wages for federal employment tax purposes. Some courts have disagreed with this position. However, *Nierotko* supports the Service's position. In addition, Service's position is that settlements including cash payments made to employees by employers in lieu of providing benefits under employer plans (for example, paid in lieu of health insurance or qualified pension plan benefits) are also wages for federal employment tax purposes, because no exception from wages applies.
>
> Back pay and front pay are wages subject to employment taxes in the year paid, and are subject to the tax rates and FICA and FUTA wage bases in effect in the year paid. *U.S. v. Cleveland Indians Baseball, Co* 532 U.S. 200 (2001).

However, the IRS Chief Counsel Memorandum distinguished between the views of the IRS and the disagreeing views of some courts:

> The Service's position is that payments constituting . . . and front pay FN4 are wages for employment tax purposes.
>
> FN4. Note that there is some disagreement among the Federal appellate circuits on the character of front pay. *Compare, e.g.*, *Gerbec v. U.S.*, 164 F.3d 1015, 1026 (6th Cir. 1999) (holding that portions of an award allocated to back wages and future wages are wages subject to FICA taxation) *with Dotson v. U.S.*, 87 F.3d 682, 689 (5th Cir. 1996) (holding that only the back pay portion of a settlement pay was wages for purposes of FICA).

4. <u>My client had to be treated by a doctor for his emotional distress, stomach ulcer, and sleeplessness after he was fired. Are his compensatory damages for emotional distress taxable?</u>

Yes. IRS Publication 525 (2013) states:

> ***Emotional distress.*** Emotional distress itself is not a physical injury or physical sickness, but damages you receive for emotional distress due to a physical injury or sickness are treated as received for the physical injury or sickness. Do not include them in your income.
>
> If the emotional distress is due to a personal injury that is not due to a physical injury or sickness (for example, unlawful discrimination or injury to reputation), you must include the damages in your income, except for any damages you receive for medical care due to that emotional distress. Emotional distress includes physical symptoms that result from emotional distress, such as headaches, insomnia, and stomach disorders.

Note that damages to reimburse medical expenses to relieve the emotional distress are not included in taxable income. If you deducted the medical expenses in an earlier year, however, they are included.

5. Are punitive damages taxable?

Almost certainly. In *O'Gilvie v. United States*, 519 U.S. 79, 82-83 (1996), the Supreme Court held that punitive damages were not damages received "on account of" personal injuries, and were therefore taxable. Congress then amended the Internal Revenue Code, 26 U.S.C. § 104(a)(2), to state:

> § 104. Compensation for injuries or sickness
>
> (a) In general.--Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include--
>
> * * *
>
> (2) the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness;

IRS Publication 525 (2013) states:

> To determine if settlement amounts you receive by compromise or judgment must be included in your income, you must consider the item that the settlement replaces. The character of the income as ordinary income or capital gain depends on the nature of the underlying claim. Include the following as ordinary income.
>
> * * *
>
> 3. Punitive damages, in most cases. It does not matter if they relate to a physical injury or physical sickness.

6. Are ADEA, FLSA, and Equal Pay Act liquidated damages taxable?

Yes. *Commissioner of Internal Revenue v. Schleier*, 515 U.S. 323, 331-32 (1995), held that ADEA liquidated damages were punitive in nature, and subject to income tax.

7. Is prejudgment interest taxable?

Yes. IRS Publication 525 (2013) states:

> To determine if settlement amounts you receive by compromise or judgment must be included in your income, you must consider the item that the settlement replaces. The character of the income as ordinary income or capital gain depends on the nature of the underlying claim. Include the following as ordinary income.
>
> * * *
>
> 1. Interest on any award.

8. How about F.I.C.A. and Medicare Taxes?

F.I.C.A. and Medicare taxes should be withheld from amounts paid by an employer for back pay. See the above cautions.

Liquidated damages under the ADEA, FLSA, and Equal Pay Act are not considered "wages" and are therefore exempt from F.I.C.A., FUTA, and Medicare taxes. The IRS Lawsuits, Awards, and Settlements Audit Techniques Guide (May 2011), states:

> "Liquidated damages" awarded under a Fair Labor Standards Act of 1938 (FLSA) settlement are not wages for federal employment tax purposes. Rev. Rul. 72-268. Under the FLSA, workers are entitled to such liquidated damages absent an employer's showing of a good faith defense "Liquidated damages" under the ADEA are similar but payable only in cases of willful violations.

9. Are Severance Payments Taxable, and "Wages" Subject to F.I.C.A. Taxes?

Yes. The Supreme Court so held in *United States v. Quality Stores, Inc.*, __ U.S. __, 134 S.Ct. 1395, 1399-1400, 188 L.Ed.2d 413 (2014). The Court stated:

> To fund benefits provided by the Social Security Act and Medicare, FICA taxes "wages" paid by an employer or received by an employee "with respect to employment." 26 U.S.C. §§ 3101(a), (b), 3111(a), (b). Congress chose to define wages under FICA "broadly." *Mayo Foundation for Medical Ed. and Research v. United States*, 562 U.S. ——, ——, 131 S.Ct. 704, 708–709, 178 L.Ed.2d 588 (2011). FICA defines "wages" as "all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash." § 3121(a). The term "employment" encompasses "any service, of whatever nature, performed ... by an employee for the person employing him." § 3121(b).
>
> Under this definition, and as a matter of plain meaning, severance payments made to terminated employees are "remuneration for employment." Severance payments are, of course, "remuneration," and common sense dictates that employees receive the payments "for employment." Severance payments are made to employees only. It would be contrary to common usage to describe as a severance payment remuneration provided to someone who has not worked for the employer. Severance payments are made in consideration for employment—for a "service ... performed" by "an employee for the person employing him," per FICA's definition of the term "employment." *Ibid.*

10. Is the IRS required to accept the parties' allocation of the amounts paid?

No. The IRS tends to accept reasonable, arm's-length settlement allocations that were arrived at adversarially, and adversarial court and jury allocations. It will not accept "friendly" allocations where both sides are simply trying to reduce taxes. It is very important to be

reasonable in the allocation. Dogs and cats and little pigs get fed; hogs get slaughtered. The IRS Lawsuits, Awards, and Settlements Audit Techniques Guide (May 2011), states:

> **Settlements Out of Court**
>
> Many lawsuits are settled prior to a jury verdict. When damages are received pursuant to a settlement agreement, the nature of the claim that was the actual basis for settlement controls whether such damages are excludable under IRC § 104(a)(2). These settlements should be closely reviewed, and the underlying facts and circumstances should be carefully determined. The allocation among the various claims of the settlement can be challenged where the facts and circumstances indicate that the allocation does not reflect the economic substance of the settlement. See these pre 1996 Amendment cases to illustrate such reallocations; *Bagley v. Commissioner,* 105 T.C. 396 (1995), *aff'd*, 121 F.3d 393 (8th Cir. 1997); *Robinson v. Commissioner,* 102 T.C 116, 122 (1994), *aff'd in part and remanded,* 70 F.3d 34 (5th Cir. 1995); *Phoenix Coal Company, Inc. v. Commissioner,* 231 F.2d 420 (2d Cir. 1956).
>
> The Court in *LeFleur v. Commissioner,* T.C. Memo. 1997-312, a pre 1996 Amendment case, addressed the reallocation issue in a case involving claims for breach of contract, emotional distress (pain and suffering), and punitive damages. In an out-of-court settlement, the parties expressly agreed to allocate $800,000 of the $1 million sum to personal injuries, $200,000 to contract, and none to punitive damages. The taxpayers included the $200,000 of settlement proceeds allocated to the contract claim in their gross income on Schedule C, and excluded the $800,000 allocated to the personal injury claim under IRC § 104(a)(2).
>
> The Service disregarded the terms of the written settlement agreement and reallocated the previously excluded $800,000 to income. The Tax Court upheld the IRS's reallocation and referring to the settlement agreement stated, "the allocation did not accurately reflect the realities of the petitioner's underlying claims." *LeFleur at 9.* In determining the $800,000 was not excludable under IRC §104(a)(2), the Court stated:
>
>> "In light of the facts and circumstances, we conclude that petitioner suffered no injury to his health that could be attributed to the actions of the defendants, and we are not persuaded that such injury was the basis of any payment to him …." *LeFleur at 10.*
>
> For additional information on issues dealing with the allocation or reallocation of settlements, see discussions of "Physical Injury or Sickness" and "Non-Physical Injury or Sickness" below.

The Audit Guide also states:

> An allocation of the settlement that is reasonable and based on the facts and circumstances of the case should generally be accepted by the Service. A statement by the employer that the settlement payment was made merely to settle the case is of little value in determining whether the payment is wages for employment tax purposes. Generally, if no specific allocation of the settlement is made, the status of the payments

would be determined by looking at the claims asserted by the plaintiff and the surrounding facts and circumstances, including the basis upon which the settlement proceeds were distributed. There has been a considerable amount of litigation in connection with the employment taxation of settlement payments; therefore, before relying on any particular case, care should be taken to verify that the case accurately reflects the Service's position.

> There is general agreement that to the extent damages are excludable from gross income, they are not subject to employment taxes. Also, there is general agreement among courts that to the extent a settlement payment made by an employer or former employer represents back pay for services by an employee for the employer, such payments are wages for employment tax purposes. Rev. Rul. 96-65.

The same Guide provides the following examples of Tax Court determinations:

> ***Bagley v. Commissioner*, 105 T.C. 396 (1995), *aff'd*, 121 F.3d 393 (8th Cir. 1997).**
>
> This case involved claims for tortious interference with current and future employment, libel, and invasion of privacy. The trial resulted in a jury verdict that was appealed. A settlement agreement was reached prior to the new trial. This settlement agreement allocated the entire award to compensatory. The Tax Court looked to the facts of the case, including the trial determinations and the negotiations for settlement. The Tax Court determined that a portion should be allocated to punitive, even though the payor stated in negotiations that they would not agree to pay punitive damages. The Tax Court determined that both parties considered the clear possibility of punitive damages being recovered. The Tax Court pointed out that the taxpayer's attorney became aware of the potential taxability of punitive damages during the negotiations.
>
> *　　　　*　　　　*
>
> ***Robinson v. Commissioner,* 102 T.C. 116 (1994), *aff'd in part, rev'd in part by Robinson v. Commissioner*., 70 F.3d 34 (5th Cir. 1995).**
>
> The taxpayer's out of court settlement allocation was set aside for tax purposes because the settlement did not represent a bona fide allocation based on an arms length negotiation.

11. <u>What if the court approves the parties' allocations?</u>

Again, this will help if the allocations are reasonable, but the IRS was not a party to the litigation and is not bound by the court's approval of the allocation. The IRS Lawsuits, Awards, and Settlements Audit Techniques Guide (May 2011), states:

> **Resolution of Claims**
>
> Determining the correct allocations among taxable payments and non-taxable payments is usually the most difficult part of an examination. Claims are generally resolved in one of two ways:

Jury/Court Verdicts

If damages have been clearly allocated to an identifiable claim in an adversarial proceeding by judge or jury, the Service will usually not challenge their character because of the impartial and objective nature of the determinations. However, care should be taken where the Court's decision is simply a ratification of a settlement entered into by the parties. *See Robinson v. Commissioner*, 102 T.C. 116, 122 (1994), *aff'd in part and remanded,* 70 F.3d 34 (5th Cir. 1995) and *Kightlinger v. Commissioner*, T.C. Memo. 1998-357. In *Robinson,* the Court incorporated the parties' allocation of damages in its judgment by reference to their settlement agreement. However, the Service successfully argued that the allocation was not a "bona fide allocation that was reached at arms length." *Robinson,* 102 T.C.at 133. Although both of these cases are pre 1996 Amendment cases, they show how in cases where there was not an impartial and objective determination of the allocation of the award to its components, a reconsideration of the allocation is warranted.

12. Payments to Undocumented Immigrants Without Valid SSNs [5]

Undocumented immigrants without valid SSNs can submit IRS Form W7 and obtain an Individual Taxpayer Identification Number. ITINs are described in IRS Publication 1915. Current IRS policy described to Congress is not to report tax information to other agencies of government, so undocumented immigrants may use this system without fear that this will subject them to deportation by the Bureau of Immigration and Customs Enforcement in the Department of Homeland Security.

Then Commissioner of Internal Revenue Mark Everson testified at a joint Congressional hearing on "Social Security Number and Individual Taxpayer Identification Number Mismatches and Misuse" before the Subcommittees on Oversight and on Social Security or the House Committee on Ways and Means on March 10, 2004. The hearing transcript is Serial No. 108–53. Commissioner Everson's prepared statement appears at p. 12 of the hearing. He stated in part:

> Notwithstanding that many ITIN holders may not be authorized to work in the United States, we are broadly restricted under Section 6103 of the Code from sharing taxpayer information with third parties, including other government agencies, except in very limited circumstances. This taxpayer information includes the possibility that the applicant is not working legally in the United States or is using an SSN that does not belong to him or her. As noted above, though, we have no legal authority with respect to the enforcement of immigration and social security administration laws.
>
> We must also weigh the potential benefits of any changes to the ITIN program against the cost of those changes to the tax system, including both direct economic costs and the indirect costs that arise from discouraging participation in the tax system. As an example, the Service believes at this time that any sharing of confidential taxpayer

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[5] Thanks to Jonathan Grode of Green & Spiegel LLC, 1524 Delancey Street, 4th Floor, Philadelphia., PA 19102, Co-Chair of the Immigration Law Committee of the ABA Section of Labor and Employment Law, for the information in this section.

> information, directly or indirectly, with immigration authorities would have a chilling effect on efforts to bring ITIN holders, and potential ITIN holders, into the U.S. tax system. Such an initiative would deprive the Federal Government of tax revenue by discouraging illegal workers in the U.S. from participating in the tax system, when the Code requires them to pay tax on their U.S. earnings.

This situation could, of course, change in the future.

13. <u>Are Attorneys' Fees Paid by a Defendant to a Plaintiff Subject to Income Tax?</u>

Yes, if the award other than attorneys' fees is itself includible in the plaintiff's income. IRS Publication 525 (2013) states:

> . . . Include the following as ordinary income.
>
> * * *
>
> 7. Attorney fees and costs (including contingent fees) where the underlying recovery is included in gross income.

The IRS Lawsuits, Awards, and Settlements Audit Techniques Guide (May 2011), states:

> **Amount to be Included in Gross Income**
>
> In all cases, including those involving contingent fee arrangements, the gross award/settlement, without diminution for attorneys' fees or costs, should be included in the taxpayer's income. This treatment is in accord with IRC § 61 and the long established principle, "the fruit of the tree" theory, that income is taxable to the person who earns it and it cannot be assigned to someone else.
>
> Taxing the gross amount from lawsuit proceeds has been often litigated and has historically been upheld in Tax Court, as well as various circuit jurisdictions. The issue was finally settled in *Commissioner v. Banks,* 543 U.S. 426 (2005). In this consolidated Supreme Court case, the Court held that attorney fees, including those paid directly to the litigant's attorney on a contingent fee basis, are fully includible in the gross income of the litigant. *Banks,* 543 U.S. at 430.

14. <u>Can the Plaintiff Take an Above-the-Line Deduction for the Full Amount of the Attorneys' Fees and Costs, in Employment and Civil Rights Cases?</u>

Yes, to the extent that the award other than attorneys' fees is itself includible in the plaintiff's income, and not in excess of the amount includible. An "above the line" deduction means one that is not subject to the exclusion of 2% of adjusted gross income, and that is not subject to the alternative minimum tax. 26 U.S.C. §§ 62(a)(20) and –(21) state:

> **(20) Costs involving discrimination suits, etc.**--Any deduction allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in

connection with any action involving a claim of unlawful discrimination (as defined in subsection (e)) or a claim of a violation of subchapter III of chapter 37 of title 31, United States Code [FN1] or a claim made under section 1862(b)(3)(A) of the Social Security Act (42 U.S.C. 1395y(b)(3)(A)). The preceding sentence shall not apply to any deduction in excess of the amount includible in the taxpayer's gross income for the taxable year on account of a judgment or settlement (whether by suit or agreement and whether as lump sum or periodic payments) resulting from such claim.

(21) Attorneys fees relating to awards to whistleblowers.--Any deduction allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any award under section 7623(b) (relating to awards to whistleblowers). The preceding sentence shall not apply to any deduction in excess of the amount includible in the taxpayer's gross income for the taxable year on account of such award.

The definition of the unlawful discrimination claims subject to 26 U.S.C. § 62(a)(20) is set forth in § 62(e). It encompasses both civil rights claims not involving employment, and employment claims not involving civil rights:

(e) Unlawful discrimination defined.--For purposes of subsection (a)(20), the term "unlawful discrimination" means an act that is unlawful under any of the following:

(1) Section 302 of the Civil Rights Act of 1991 (2 U.S.C. 1202).

(2) Section 201, 202, 203, 204, 205, 206, or 207 of the Congressional Accountability Act of 1995 (2 U.S.C. 1311, 1312, 1313, 1314, 1315, 1316, or 1317).

(3) The National Labor Relations Act (29 U.S.C. 151 et seq.).

(4) The Fair Labor Standards Act of 1938 (29 U.S.C. 201 et seq.).

(5) Section 4 or 15 of the Age Discrimination in Employment Act of 1967 (29 U.S.C. 623 or 633a).

(6) Section 501 or 504 of the Rehabilitation Act of 1973 (29 U.S.C. 791 or 794).

(7) Section 510 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1140).

(8) Title IX of the Education Amendments of 1972 (20 U.S.C. 1681 et seq.).

(9) The Employee Polygraph Protection Act of 1988 (29 U.S.C. 2001 et seq.).

(10) The Worker Adjustment and Retraining Notification Act (29 U.S.C. 2102 et seq.).

(11) Section 105 of the Family and Medical Leave Act of 1993 (29 U.S.C. 2615).

(12) Chapter 43 of title 38, United States Code (relating to employment and reemployment rights of members of the uniformed services).

(13) Section 1977, 1979, or 1980 of the Revised Statutes (42 U.S.C. 1981, 1983, or 1985).

(14) Section 703, 704, or 717 of the Civil Rights Act of 1964 (42 U.S.C. 2000e-2, 2000e-3, or 2000e-16).

(15) Section 804, 805, 806, 808, or 818 of the Fair Housing Act (42 U.S.C. 3604, 3605, 3606, 3608, or 3617).

(16) Section 102, 202, 302, or 503 of the Americans with Disabilities Act of 1990 (42 U.S.C. 12112, 12132, 12182, or 12203).

(17) Any provision of Federal law (popularly known as whistleblower protection provisions) prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted under Federal law.

(18) Any provision of Federal, State, or local law, or common law claims permitted under Federal, State, or local law--

(i) providing for the enforcement of civil rights, or

(ii) regulating any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.

15. What Happens if the Settlement Agreement or Court Order Does Not Provide a Specific Amount for Fees and Expenses?

If the settlement agreement or court order does not allocate a specific amount for attorneys' fees and expenses, the entire amount is considered "wages" and is subject to F.I.C.A. and Medicare taxes. IRS Rev. Rul. 80-364, 1980-52 I.R.B. 15, 1980-2 C.B. 294, 1980 WL 130164, "Legal Fees and Interest Awarded with Back Pay," describes three situations and states the different tax treatment of each:

Situation 1. After termination of employment by a company, an individual filed a complaint against the company for back pay owed to the individual. The court awarded the individual 8x dollars as back pay, and also awarded interest of 1x dollars and an attorney's fee of 1x dollars.

Situation 2. An individual sued the individual's employer for 15x dollars for back pay. Pursuant to a court order the employer made a payment to the employee of 10x dollars. The court order did not indicate that a portion of the award was attorney's fees or

interest. The employee paid 1x dollars for an attorney's fee which was paid out of the award.

> Situation 3. Due to a breach of a collective bargaining agreement a union filed claims on behalf of its members against a company. Subsequently, the union and the company entered into a settlement agreement, later approved by a federal district court, that provided that the company would pay the union 40x dollars in full settlement of all claims. The union paid 6x dollars of the settlement for attorney's fees and returned 34x dollars to the employees for back pay owed to them. The back pay was distributed among the employees in proportion to their claims.

The IRS's resolution of these situations is as follows:

> In Situation 1, while the full amount of the award is income to the employee and must be included in the employee's gross income, only the back pay award of 8x dollars is wages for federal employment tax purposes. The payments for interest and the attorney's fee are not wages, because they are not remuneration for employment.
>
> In Situation 2, the full amount of the award is income to the employee and it is also wages for federal employment tax purposes, notwithstanding that a portion of it was spent on attorney's fees.
>
> In Situation 3, the amount of the settlement paid by the union for attorney's fees is not remuneration to the individual employees and, therefore, is not wages for purposes of the federal employment taxes. The attorney's fees portion of the settlement is a reimbursement for expenses incurred by the union to enforce the collective bargaining agreement. The amount allocated to attorney's fees is not includible in the gross income of the individual employees and the individual employees may not deduct the attorney's fees as a business expense. Compare Rev. Rul. 58-301, 1958-1 C.B. 23.

The IRS Chief Counsel Memorandum states that the same reasoning applies to settlements:

> Although Rev. Rul. 80-364 addresses court awards in the back pay context and not settlements of claims outside of court, the reasoning in the ruling can be extended to settlement payments. When an employment-related claim brought under a fee-shifting statute is settled outside of court and the settlement agreement clearly allocates a reasonable amount of the settlement proceeds as attorney's fees, the amount allocated to attorney's fees, while includable in income, is not wages for employment tax purposes. On the other hand, if the settlement agreement does not clearly allocate an amount for attorney's fees, and/or the claim is brought under a statute that does not provide for fee-shifting, the entire amount paid to the claimant-employee is wages for employment tax purposes.

F.I.C.A. taxes are 6.2% on the employee and on the employer for the first $117,000 of pay, and Medicare taxes are an additional 1.45% of payroll. The Federal Unemployment Tax is 6% of the first $7,000 of payroll, payable only by the employer. See IRS Publication 15.

As a result, failure to specify the amount of fees and expenses in a judgment, court order, or settlement will cost the employee 7.65% of that amount up to $117,000, and will cost the

employer an additional 7.65% of that amount up to $117,000, plus up to $420 in FUTA taxes. Taking these tax considerations into account may leave a little more money on the table, and help to bridge a gap between the parties in settlement.

Because it is in both sides' interest not to pay F.I.C.A. and Medicare taxes on attorneys' fees and expenses, and it is in the employer's interest not to pay Federal and State unemployment compensation taxes on attorneys' fees and expenses, the best practice is to specify the amount being paid for fees and expenses.

16. What Forms Are Used to Report Payments of Attorneys' Fees and Expenses?

The full amount of the attorneys' fees and expenses paid by the defendant—or by the entity against which a claim was asserted and which paid, must be included in the income reported as paid to the plaintiff or claimant, whether or not the attorney was paid separately. As shown above, the payment will be reported on a Form 1099-MISC when the amount of the attorneys' fees and expenses are specified, and on a Form W-2 when they are not specified.

IRS regulation 26 C.F.R. § 6041-1(f) provides:

> **(f) Amount to be reported when fees, expenses or commissions are deducted-- (1) In general.** The amount to be reported as paid to a payee is the amount includible in the gross income of the payee (which in many cases will be the gross amount of the payment or payments before fees, commissions, expenses, or other amounts owed by the payee to another person have been deducted), whether the payment is made jointly or separately to the payee and another person. The Commissioner may, by guidance published in the Internal Revenue Bulletin, illustrate the circumstances under which the gross amount or less than the gross amount may be reported.
>
> **(2) Examples.** The provisions of this paragraph (f) are illustrated by the following examples:
>
> **Example 1.** Attorney P represents client Q in a breach of contract action for lost profits against defendant R. R settles the case for $100,000 damages and $40,000 for attorney fees. Under applicable law, the full $140,000 is includible in Q's gross taxable income. R issues a check payable to P and Q in the amount of $140,000. R is required to make an information return reporting a payment to Q in the amount of $140,000. For the rules with respect to R's obligation to report the payment to P, see section 6045(f) and the regulations thereunder.
>
> **Example 2.** Assume the same facts as in Example 1, except that R issues a check to Q for $100,000 and a separate check to P for $40,000. R is required to make an information return reporting a payment to Q in the amount of $140,000. For the rules with respect to R's obligation to report the payment to P, see section 6045(f) and the regulations thereunder.

17. What Tax Forms Does the Attorney Receive?

IRS regulation 26 C.F.R. § 1.6045–5(a)(1) requires reports of payments to attorneys amounting to $600 or more in a year for legal services, whether or not all or part of the payment must also be reported on other forms. Subsec. (a)(2) requires the recipient attorney to provide his or her Taxpayer Identification Number so that the employer can make the required reports.

Where more than one attorney is listed as a payee on the check, subsec. (b)(2) requires the payee attorney subject to the payor's information return to file information returns as to other payee attorneys:

> **(2) Attorney required to report payments made to other attorneys.** If an information return is required to be filed with respect to a payee attorney under paragraph (b)(1) of this section, the attorney with respect to whom the information return is required to be filed (tier-one attorney) must file an information return under this section for any payment that the tier-one attorney makes to other payee attorneys with respect to that check, regardless of whether the tier-one attorney is a payor under paragraph (d)(3) of this section.

Subsec. (f) provides examples:

> **(f) Examples.** The following examples illustrate the provisions of this section. The examples assume that P is not a payor with respect to A, the attorney, under section 6041. See section 6041 and the regulations thereunder for rules regarding whether P is required under section 6041 to file information returns with respect to C. The examples are as follows:
>
> **Example 1.** One check--joint payees--taxable to claimant. Employee C, who sues employer P for back wages, is represented by attorney A. P settles the suit for $300,000. The $300,000 represents taxable wages to C under existing legal principles. P writes a settlement check payable jointly to C and A in the amount of $200,000, net of income and FICA tax withholding with respect to C. P delivers the check to A. A retains $100,000 of the payment as compensation for legal services and disburses the remaining $100,000 to C. P must file an information return with respect to A for $200,000 under paragraph (a)(1) of this section. P also must file an information return with respect to C under sections 6041 and 6051, in the amount of $300,000. See §§ 1.6041–1(f) and 1.6041–2.
>
> **Example 2.** One check--joint payees--excludable to claimant. C, who sues corporation P for damages on account of personal physical injuries, is represented by attorney A. P settles the suit for a $300,000 damage payment that is excludable from C's gross income under section 104(a)(2). P writes a $300,000 settlement check payable jointly to C and A and delivers the check to A. A retains $120,000 of the payment as compensation for legal services and remits the remaining $180,000 to C. P must file an information return with respect to A for $300,000 under paragraph (a)(1) of this section. P does not file an information return with respect to tax-free damages paid to C.

Example 3. Separate checks--taxable to claimant. C, an individual plaintiff in a suit for lost profits against corporation P, is represented by attorney A. P settles the suit for $300,000, all of which will be includible in C's gross income. A requests P to write two checks, one payable to A in the amount of $100,000 as compensation for legal services and the other payable to C in the amount of $200,000. P writes the checks in accordance with A's instructions and delivers both checks to A. P must file an information return with respect to A for $100,000 under paragraph (a)(1) of this section. Pursuant to § 1.6041–1(a) and (f), P must file an information return with respect to C for the $300,000.

Example 4. Check made payable to claimant, but delivered to nonpayee attorney. Corporation P is a defendant in a suit for damages in which C, the plaintiff, has been represented by attorney A throughout the proceeding. P settles the suit for $300,000. Pursuant to a request by A, P writes the $300,000 settlement check payable solely to C and delivers it to A at A's office. P is not required to file an information return under paragraph (a)(1) of this section with respect to A, because there is no payment to an attorney within the meaning of paragraph (d)(4) of this section.

Example 5. Multiple attorneys listed as payees. Corporation P, a defendant, settles a lost profits suit brought by C for $300,000 by issuing a check naming C's attorneys, Y, A, and Z, as payees in that order. Y, A, and Z do not belong to the same law firm. P delivers the payment to A's office. A deposits the check proceeds into a trust account and makes payments by separate checks to Y of $30,000 and to Z of $15,000, as compensation for legal services, pursuant to authorization from C to pay these amounts. A also makes a payment by check of $155,000 to C. A retains $100,000 as compensation for legal services. P must file an information return for $300,000 with respect to A under paragraphs (a)(1) and (b)(1)(i) of this section. A, in turn, must file information returns with respect to Y of $30,000 and to Z of $15,000 under paragraphs (a)(1) and (b)(2) of this section because A is not required to file information returns under section 6041 with respect to A's payments to Y and Z because A's role in making the payments to Y and Z is merely ministerial. See § 1.6041–1(e)(1), (e)(2) and (e)(5) Example 7 for information reporting requirements with respect to A's payments to Y and Z. As described in Example 3, P must also file an information return with respect to C, pursuant to § 1.6041–1(a) and (f).

Example 6. Amount of the payment--attorney does not provide TIN. (i) Corporation P, a defendant, settles a suit brought by C for $300,000 of damages. P will pay the damages by a joint check to C and his attorney, A. A failed to furnish P with A's TIN. P is required to deduct and withhold 28 percent tax from the $300,000 under section 3406(a)(1)(A) and paragraph (e) of this section. P writes the check to C and A as joint payees, in the amount of $216,000. P also must file an information return with respect to A under paragraph (a)(1) of this section in the amount of $300,000, as prescribed in paragraph (d)(5) of this section. If the damages are reportable under section 6041 because they are not excludable from gross income under existing legal principles, and are not subject to any exception under section 6041, P must also file an information return with respect to C pursuant to § 1.6041–1(a) and (f) in the amount of $300,000.

(ii) Rather than paying by joint check to C and A, P will pay the damages by a joint check to C and F, A's law firm. F failed to furnish its TIN to P. P is required to deduct and withhold 28 percent tax from the $300,000 under section 3406(a)(1)(A) and paragraph (e) of this section. P writes the check to C and F as joint payees, in the amount of $216,000. P also must file an information return with respect to F under paragraph (a)(1) of this section in the amount of $300,000, as prescribed in paragraph (d)(5) of this section. If the damages are reportable under section 6041 because they are not excludable from gross income under existing legal principles, and are not subject to any exception under section 6041, P must also file an information return with respect to C pursuant to § 1.6041–1(a) and (f) in the amount of $300,000.

* * *

Example 9. Qualified settlement fund. Corporation P agrees to settle for $300,000 a class action lawsuit brought by attorney A on behalf of a claimant class. Pursuant to the settlement agreement and a preliminary order of approval by a court, A establishes a bank account in the name of Q Settlement Fund, which is a qualified settlement fund (QSF) under § 1.468B–1. A is also designated by the court as the administrator of the QSF. Corporation P transfers $300,000 by wire in Year 1 to A, who deposits the funds into the Q Settlement Fund. In Year 2, the court approves an award of attorney's fees of $105,000 for A. In Year 2, Q Settlement Fund delivers $105,000 to A. P is required to file an information return under paragraph (a) of this section with respect to A for Year 1 for the $300,000 payment it made to A. The Q Settlement Fund is required to file an information return under section 6041(a) and § 1.468B–2(l)(2) with respect to A for Year 2 for the $105,000 payment it made to A.

J. <u>409A Problems</u>

Internal Revenue Code § 409A, 26 U.S.C. § 409A, is both highly technical and highly important. It does not just apply to key employees, but to any employee receiving deferred compensation.

There are a number of guides to make navigating these questions easier. See the following articles on the web, all visited on June 16, 2015:

Mims Maynard Zabriskie, David B. Zelikoff, and Vicki M. Nielsen, of Morgan Lewis & Bockius, "Avoiding 409A Pitfalls in Severance Agreements," http://morganlewis.com/pubs/EB_Avoiding409APitfalls_10april12.pdf.

Durward J. "Jim" Gehring, Seyfarth Shaw LLP, Practical law Company, "Applying Section 409A to Severance Benefits," http://www.seyfarth.com/dir_docs/news_item/baa36085-d2a4-4ef3-bfb1-67338f98ae90_documentupload.pdf.

John F. McGuiness, Groom Law Group, "Spotting Section 409A Issues in Executive Separation Agreements." BNA Pension & Benefits Daily (June 2, 2009), http://www.groom.com/resources-370.html.

Jeffrey J. Bakker, Patricia S. Cain, and Stephanie B. Vasconcellos, Neal, Gerber & Eisenberg LLP, "Are Your Employment Agreements Section 409A Proof? Don't let non-compliance trigger drastic tax consequences," National Law Review (September 21, 2012), http://www.natlawreview.com/article/are-your-employment-agreements-section-409a-proof-don-t-let-non-compliance-trigger-d.

Rory D. Lyons, Jones Day, "Section 409A's Impact on Employment Agreements and Severance Arrangements" (April 2006), http://www.jonesday.com/section-409as-impact-on-employment-agreements-and-severance-arrangements-04-05-2006/.

McGuire Woods Legal Alert, "Employee Release Provisions Present Section 409A Trap for the Unwary" (August 31, 2011), https://www.mcguirewoods.com/Client-Resources/Alerts/2011/8/Employee-Release-Provisions-Present-Section-409A-Trap-for-the-Unwary.aspx.

Michael L. Rosen and Teresa A. Martland, Foley Hoag, "Section 409A (Deferred Compensation) Issues in Employment Agreements" (March 5, 2012), http://www.americanbar.org/content/dam/aba/events/labor_law/2012/03/employment_rights_responsibilities_committee_midwinter_meeting/28.authcheckdam.pdf.

Amy Hwang, Mary E. Drobka and Stuart C. Harris, Davis Wright Tremaine LLP, "Dec. 31 Deadline for Severance Pay Provisions in Employment Agreements to Comply With Section 409A" (October 11, 2012), http://www.dwt.com/Dec-31-Deadline-for-Severance-Pay-Provisions-in-Employment-Agreements-to-Comply-With-Section-409A-10-11-2012/.

A. William Caporizzo, R. Scott Kilgore, Amy A. Null, Linda K. Sherman, Kimberly B. Wethly, Wilmer Hale, "Severance Pay under the Final Section 409A Regulations" (May 25, 2007), https://www.wilmerhale.com/pages/publicationsandNewsDetail.aspx?NewsPubId=94017.