

PLAINTIFFS' ATTORNEYS BEWARE:
LITTLE KNOWN TAX CONSEQUENCES
ASSOCIATED WITH
CONFIDENTIALITY PROVISIONS

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I.	INTRODUCTION: CONFIDENTIALITY AS A COMMODITY FOR TAX PURPOSES—THE VALUE OF A SECRET.....	258
II.	GENERAL RULES FOR A SECTION 104(A)(2) PERSONAL INJURY EXCLUSION	260
III.	THE AMOS CASE AND ITS AFFECT ON TAXING CONFIDENTIALITY.....	262
	A. <i>Introduction to Amos</i>	262
	B. <i>Issues</i>	263
	C. <i>Holding 1: Amos Allowed to Exclude More than a Nominal Amount of the Settlement Proceeds</i>	263
	D. <i>Holding 2: The Bifurcation of Taxable and Excludable Proceeds</i>	265
	E. <i>Consequences of Amos</i>	267
IV.	SUGGESTIONS TO AVOID POTENTIAL PROBLEMS	268
	A. <i>If Possible, Do Not Agree to the Inclusion of a Confidentiality Provision</i>	268
	B. <i>Minimize the Confidentiality Component</i>	269
	C. <i>Use Express Language</i>	269
	D. <i>Require the Defendant to Indemnify the Plaintiff for Adverse Tax Consequences</i>	273
	E. <i>Make a Claim for Physical Injury Early in the Settlement Process</i>	274
	F. <i>Obtain a Private I.R.S. Ruling</i>	275
	G. <i>Remember the Rule Against Compounding and Other Ethical Concerns</i>	275
	H. <i>Consider Demanding Extra Money for the Inclusion of a Confidentiality Provision</i>	277
V.	CONCLUSION.....	278

258 HOUSTON BUSINESS AND TAX LAW JOURNAL [Vol. VI

I. INTRODUCTION: CONFIDENTIALITY AS A COMMODITY FOR TAX PURPOSES—THE VALUE OF A SECRET

Historically speaking, confidentiality provisions in personal injury settlement agreements have not been separately taxed because they were presumed to be part of an exclusion from gross income under Internal Revenue Code § 104(a)(2) for physical personal injury.¹ However, trial lawyers from both sides of the bar should be aware that confidentiality provisions may now be considered taxable income as courts are beginning to view secrecy as a commodity for sale in the marketplace.² In *Amos v. Comm'r*,³ a case that has flown under the radar screen of most practitioners, the United States Tax Court broke the historical presumption discussed above and approved the notion of taxing the portion of settlement proceeds attributable to the confidentiality provisions of a physical injury settlement agreement.⁴

The *Amos* court holding reflects the view that confidentiality can sometimes be seen as being of a separate nature from the personal injury settlement agreement of which it is a part. The basis for such a view is the conceptualization that the contractual obligation of secrecy, which is created by the confidentiality provisions in the settlement agreement, is something that can be bought and sold.⁵ What is being sold when a plaintiff negotiates using confidentiality as a commodity is a contractual obligation that eliminates the access right of the outside public to the information acquired by the plaintiff and his or her attorney while prosecuting the plaintiff's claims.⁶ What is being bought by a defendant in such a case is the contractual right to have certain information kept secret from the public, which sometimes includes closing the practice of the plaintiff's attorney to others who may seek that attorney's help in suing the defendant/buyer.⁷ For this reason,

1. I.R.C. § 104(a)(2) (1994).

2. See John Freeman, *Another Reason to Avoid Confidential Settlements: Taxation*, 16 S. CAROLINA LAWYER 9 (2004) (discussing briefly the potential ethical and tax consequences associated with viewing confidentiality as a commodity).

3. 86 T.C.M. (CCH) 663 (2003).

4. *Id.* at 664-65, 667.

5. See David A. Dana & Susan P. Koniak, *Secret Settlements and Practice Restrictions Aid Lawyer Cartels and Cause Other Harms*, 2003 U. ILL. L. REV. 1217, 1218 (2003) (discussing how secret settlement agreements use confidentiality as a commodity and using that framework in support of their argument for ethical and legal rules prohibiting confidentiality provisions in settlement contracts).

6. *Id.* at 1218-19.

7. *Id.* at 1219.

The confidentiality component of a secret settlement may have a high value [to the defendant] precisely because the defendant's conduct has been egregious and has injured many other victims. Keeping those other victims in the dark concerning the existence of their claims or the true value of their claims may make good business sense to the defendant.⁸

Conversely, the defendant "may have a legitimate interest in keeping certain information from the public, such as trade secrets or intimate information."⁹ Similarly, a plaintiff may, for a variety of reasons, be willing to sign a confidential settlement agreement without either intent to sell his or her confidentiality obligation as a commodity or without receiving any extra compensation for its inclusion because he or she simply wants to settle the case and move on with his or her life. However, regardless of either party's intentions for wanting to enter into a confidential settlement, the *Amos* case must cause plaintiffs' attorneys to stop and examine these confidentiality provisions in greater detail before advising a plaintiff to sign a settlement agreement containing one or more of them in its contractual terms.

This paper is designed to provide an in-depth look at the current issue of taxing proceeds from personal injury settlement agreements that are attributable to confidentiality provisions and suggests ways to either avoid or minimize the adverse risks such taxation can have on plaintiffs receiving those proceeds. Section II of this paper discusses the general rules and requirements for Internal Revenue Code § 104(a)(2) (hereinafter "104(a)(2)") exclusions of settlement proceeds stemming from physical personal injury or sickness. Section III provides a detailed analysis of the *Amos* case, which is the seminal case regarding taxation of confidentiality provisions in personal injury settlements. Finally, Section IV suggests an array of techniques that can be used to either eliminate tax concerns stemming from confidentiality provisions or at least minimize their adverse effects on the plaintiff's settlement proceeds.

8. Freeman, *supra* note 2, at 9.

9. Dana & Koniak, *supra* note 5, at 1219.

260 HOUSTON BUSINESS AND TAX LAW JOURNAL [Vol. VI

II. GENERAL RULES FOR A SECTION 104(A)(2) PERSONAL INJURY EXCLUSION

The Federal Income Tax Rules (“Federal Rules”) provide a “sweeping” definition of “gross income” from which individuals are required to calculate their taxable income.¹⁰ Section 61(a) defines gross income: “Except as otherwise provided in this subtitle, gross income means all income from whatever source derived.”¹¹ Adding to the sweeping language of 61(a), Supreme Court decisions require that “exclusions from gross income must be narrowly construed.”¹²

However, 104(a)(2) provides a narrow exclusion from “gross income” that is applicable for damages received on account of personal physical injuries or sickness.¹³ Section 104(a)(2) states that gross income does not include “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.”¹⁴ The exclusion of an award from gross income based on 104(a)(2) “hinges on whether it actually compensates for personal injury or does something else.”¹⁵ The regulations under 104(a)(2) clarify this point: “The term “damages received (whether by suit or agreement)” means an amount received (other than workmen’s compensation) through prosecution of a legal suit or action *based upon tort or tort-type rights*, or through a settlement agreement entered into in lieu of such prosecution.”¹⁶ Thus, while it is axiomatic that the exclusion requires a personal injury or sickness, “not all recoveries growing out of an action based on a personal physical injury are excludable under 104(a)(2).”¹⁷

In order to determine what awards merit 104(a)(2) tax exclusion, the Supreme Court set up a two-pronged test in *Comm’r v. Schleier*.¹⁸ The first prong of the *Schleier* test requires the award to be “based upon tort or tort-type rights,” while the

10. *Amos v. Comm’r*, 86 T.C.M. (CCH) 663, 665 (2003).

11. I.R.C. § 61(a) (1994).

12. *Amos*, 86 T.C.M. at 665 (citing to *Comm’r v. Schleier*, 515 U.S. 323, 328 (1995)).

13. I.R.C. § 104(a)(2) (1994).

14. *Id.*

15. *Exclusion for Awards for Injuries or Sickness (Section 104(a)(2))*, 56-13 USC L. SCH. INST. ON MAJOR TAX PLANNING ¶ 1308, at 1308.1 (2004) [hereinafter USC TAX PLANNING].

16. 26 C.F.R. § 1.104-1(c) (2005) (emphasis added).

17. USC TAX PLANNING, *supra* note 15, at 1308.1 (giving economic damages from breach of contract as an example).

18. *Comm’r v. Schleier*, 515 U.S. 323, 336-37 (1995); see USC TAX PLANNING, *supra* note 15, at 1308.1 (discussing other courts’ application of *Schleier*’s two-pronged test).

second prong requires that the award be paid "on account of [physical] personal injuries or [physical] sickness."¹⁹ The physical injury requirement was added to the *Schleier* test after Congress amended 104(a)(2) in the Small Business Job Protection Act of 1996.²⁰ The *Amos* Court summarized these changes as follows:

Emotional distress is not to be treated as a physical injury or physical sickness for purposes of sec. 104(a)(2), except for damages not in excess of the amount paid for medical care attributable to emotional distress. In this connection, the legislative history of the 1996 amendment states: "It is intended that the term emotional distress includes symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such emotional distress."²¹

Except for the addition of the physicality requirement to the *Schleier* test, the 1996 amendments had no other effect on the 104(a) exclusion analysis.²²

Whether or not the two prongs of the *Schleier* test are met depends on how the settlement proceeds are characterized for tax purposes.²³ The tax characterization of the proceeds in turn depends upon the *nature* of the claim(s) for which it was settled and not upon the claim's validity.²⁴ To determine the nature of a claim, one must look at all the facts and circumstances behind the case from which the claim arose, "including the pleadings, testimony by both parties to the action, and the settlement agreement."²⁵ Although relevant, "self-serving statements or beliefs by the plaintiff are often discounted if not corroborated by other evidence."²⁶ Ultimately, however, without "express language stating what the amount paid pursuant to that agreement was to settle," courts focus on the *intent of the payor*, which is characterized as "the dominant reason of the payor in making the payment."²⁷

19. USC TAX PLANNING, *supra* note 15, at 1308.1.

20. *Amos v. Comm'r*, 86 T.C.M. (CCH) 663, 665-66 (2003); Small Business Job Protection Act of 1996, Pub. L. 104-188, § 1605, 110 Stat. 1755, 1838-1839.

21. *Amos*, 86 T.C.M. at 666 n.4 (citing H. Conf. Rept. 104-737, at 301 n.56 (1996), 1996-3 C.B. 741, 1041 n.56).

22. *Id.* at 665-66.

23. *Id.* at 666.

24. *Id.*

25. USC TAX PLANNING, *supra* note 15, at 1308.2; *Amos*, 86 T.C.M. at 666.

26. USC TAX PLANNING, *supra* note 15, at 1308.2; *Amos*, 86 T.C.M. at 666.

27. *Amos*, 86 T.C.M. at 664; *see* USC TAX PLANNING, *supra* note 15, at 1308.2; Fono

262 *HOUSTON BUSINESS AND TAX LAW JOURNAL* [Vol. VI]

It is also important to note that in cases such as *Amos*, where the claimant/payee seeks to challenge in court an I.R.S. assessment that the income excluded by the claimant under 104(a)(2) is actually taxable as gross income, the claimant bears the burden of proving to the court that the I.R.S. assessment is erroneous.²⁸

III. THE *AMOS* CASE AND ITS AFFECT ON TAXING CONFIDENTIALITY

A. *Introduction to Amos*

The underlying facts of the *Amos* case are well known to many sports fans who follow the NBA. Dennis Rodman, a professional basketball player for the Chicago Bulls, fell onto some photographers while playing a basketball game on January 15, 1997.²⁹ While getting up, he kicked photographer Eugene Amos in the groin, causing him physical injuries.³⁰ Amos claimed to suffer from a shooting pain that ran from his groin to his neck, but such pain was found to be subsiding as of the time he was examined in Hennepin County Medical Center ("HCMC").³¹ In fact, medical personnel did not notice any signs of trauma to Amos other than a limp and his complaints of pain.³² After a dispute with HCMC, Amos left without being discharged and without taking the pain medication prescribed by the hospital for his alleged pain.³³

The next day, Amos sought treatment at the Veterans Affairs (VA) Medical Center.³⁴ He again complained of pain in his groin but did not advise the VA medical personnel that the pain was the result of Rodman's kick.³⁵ After taking x-rays of Amos's back, the VA medical personnel determined that his back was actually in the same condition as it was before the incident with Rodman and that there was no swelling of his groin area; however, they could not determine with certainty if there was any bruising in that area.³⁶

v. Comm'r, 79 T.C. 680, 696 (1982).

28. USCS TAX CT. R. 142(a)(1); *Amos*, 86 T.C.M. at 667.

29. *Amos*, 86 T.C.M. at 663.

30. *Id.*

31. *Id.*

32. *Id.*

33. *Id.* at 663-64.

34. *Id.* at 664.

35. *Amos*, 86 T.C.M. at 663.

36. *Id.*

Between hospital visits, Amos obtained a lawyer and filed a police report with the Minneapolis Police Department claiming Rodman had assaulted him.³⁷ Shortly thereafter, Rodman's attorney contacted Amos's attorney and they negotiated a confidential settlement/release agreement for \$200,000.³⁸ For the taxable year in which the settlement proceeds were paid, Amos filed a tax return but excluded from his taxable gross income the \$200,000 that he received from Rodman under the settlement agreement.³⁹ After auditing Amos's finances, the I.R.S. Commissioner determined that Amos was not entitled to exclude any of the settlement proceeds from his gross income, except for a nominal amount (*i.e.* \$1).⁴⁰ Amos then challenged the Commissioner's decision in Federal Tax Court.⁴¹

B. *Issues*

The basic dispute between Amos and the I.R.S. stemmed from each party's conflicting view on how much of the settlement proceeds were entitled to be excluded from Amos's gross income under 104(a)(2).⁴² As previously stated, the I.R.S. contended that only a nominal amount of the settlement proceeds could be legally excluded, while Amos contended that the entire \$200,000 should be legally excluded.⁴³ Consequently, it was necessary for the United States Tax Court in *Amos* to decide (1) whether the settlement proceeds could be legally excluded from Amos's gross income and (2) if so, what percentage, if not the entire amount, could be properly excluded.⁴⁴

C. *Holding 1: Amos Allowed to Exclude More than a Nominal Amount of the Settlement Proceeds*

On the first issue, the *Amos* court found under the facts of the case that more than a nominal amount of the settlement agreement could be legally excluded from Amos's gross income.⁴⁵ In a losing effort, the I.R.S. contended that the evidence introduced to prove Amos suffered any physical injuries as a result of Rodman's kick was insufficient, especially in that

37. *Id.*

38. *Id.*

39. *Id.* at 665.

40. *Id.* at 665-66.

41. *See Amos*, 86 T.C.M. at 665.

42. *Id.*

43. *Id.*

44. *Id.* at 665-67.

45. *Id.* at 666.

Rodman himself was skeptical of petitioner's injuries.⁴⁶ The *Amos* court squarely rejected this argument finding that the I.R.S.' contention appeared "to ignore the well-established principal under section 104(a)(2) that it is the nature and character of the claim settled, *and not its validity*, that determines whether the settlement payment is excludable from gross income under section 104(a)(2)."⁴⁷

Moreover, the *Amos* court found that "Rodman's dominant reason in paying the settlement amount at issue was petitioner's claimed physical injuries" resulting from the fateful kick to the groin.⁴⁸ In making this determination, the court relied on the actual language of the settlement agreement, a declaration of Rodman's intent as payor, and the testimony of the petitioner's lawyer.⁴⁹ The court summarized the determinative evidence as follows:

The settlement agreement expressly provided that Mr. Rodman's payment of the settlement amount at issue

releases and forever discharges. . .[Mr.] Rodman. . .from any and all claims and causes of action of any type, known and unknown, upon and by reason of any damage, loss or injury. . .sustained by Amos [petitioner] arising, or which could have arisen, out of or in connection with. . .[the incident].

Mr. Rodman stated in Mr. Rodman's declaration that he entered into the settlement agreement "to resolve any potential claims" and that the settlement agreement was intended to resolve petitioner's "claim without having to expend additional defense costs." The only potential claims of petitioner that are disclosed by the record are the potential claims that petitioner had for the physical injuries that he claimed he sustained as a result of the incident. Furthermore, [petitioner's lawyer] testified that Mr. Rodman paid the entire settlement amount at issue to petitioner on account of his physical injuries.⁵⁰

46. *Id.*

47. *Amos*, 86 T.C.M. at 666 (emphasis added).

48. *Id.* at 667.

49. *Id.* at 666-67.

50. *Id.* (substituting "petitioner's lawyer" for "Ms. Pearson") (all other brackets in

The court found this evidence sufficient to demonstrate that Rodman's dominant intent was to compensate Amos for his physical injuries.⁵¹

In addition, the *Amos* court rejected the I.R.S.' second contention that since the liquidated damages for breaching the confidentiality provision under the settlement agreement (\$200,000) were equal to the proceeds of the settlement agreement (\$200,000), Rodman did not intend to compensate the petitioner for his injuries.⁵² Instead, the court simply found that "the amount of liquidated damages payable under the settlement agreement [was not] determinative of the reason for which Mr. Rodman paid petitioner the settlement amount at issue."⁵³ In rejecting the I.R.S.' main contentions, the court held that Amos was legally entitled to exclude more than a nominal amount of the settlement proceeds from his gross taxable income; however, the question still remained as to whether the 104(a)(2) exclusion would apply to all of the settlement proceeds or just a mere percentage.⁵⁴

D. *Holding 2: The Bifurcation of Taxable and Excludable Proceeds*

Although the *Amos* court found that "Rodman's dominant reason for paying petitioner the settlement amount at issue was to compensate him for his claimed physical injuries relating to the incident," the court also found that the settlement agreement expressly provided payment to Amos to maintain confidentiality and cease criminal prosecution against Rodman.⁵⁵ By so finding, the court rejected Amos's claim that "Rodman paid him the entire amount on account of the physical injuries that he claimed he sustained as a result of the incident."⁵⁶ In rejecting Amos' claim, the court specifically relied on the language of the confidentiality provisions in the settlement agreement, the relevant portions of which are as follows:

It is further understood that *part of the consideration* for this Agreement and Release includes an agreement that Rodman and Amos shall not at any time from the date of this

original).

51. *Id.* at 666.

52. *Id.*

53. *Amos*, 86 T.C.M. at 664.

54. *Id.* at 667.

55. *Id.*

56. *Id.* at 666.

Agreement and Release forward disparage or defame each other.

It is further understood and agreed that, as *part of the consideration* for this Agreement and Release, the terms of this Agreement and Release shall forever be kept confidential. . .

It is further understood and agreed that Amos and his representatives, agents, legal counsel or other advisers shall not, from the date of this Agreement and Release, disclose, disseminate, publicize or instigate or solicit any others to disclose, disseminate or publicize, any of the allegations or facts relating to the Incident. . . In this regard, Amos agrees not to make any further public statement relating to Rodman or the Incident or to grant any interviews relating to Rodman or the Incident. . .

It is further understood and agreed that any material breach by Amos or his attorney, agent or representative of the terms of this Agreement and Release will result in immediate and irreparable damage to Rodman, and that the extent of such damage would be difficult, if not impossible to ascertain. . .

Amos further represents, promises and agrees that, *as part of the consideration* for this Agreement and Release, he has communicated to the Minneapolis Police Department that he does not wish to pursue a criminal charge against Rodman, and that he has communicated that he will not cooperate in any criminal investigation concerning the Incident.⁵⁷

Interpreting these provisions, the court found that part of the proceeds Amos received from the settlement agreement were in exchange for his “agreement not to: “(1) Defame Mr. Rodman, (2) disclose the existence or the terms of the settlement agreement, (3) publicize facts relating to the incident, or (4) assist in any criminal prosecution against Mr. Rodman with respect to the incident (collectively, the nonphysical injury provisions).”⁵⁸ As the title “nonphysical injury provisions” suggests, the court found that these provisions did not fall within the scope of 104(a)(2) exclusion claims, which require “physical injury or physical

57. *Id.* at 664-65 (emphasis added).

58. *Id.* at 667.

sickness.”⁵⁹ Hence, by treating the nonphysical injury provisions differently from the provisions relating to Amos’s release of tort claims against Rodman for physical injury, the court treated the confidentiality and cease-prosecution provisions as separate commodities within the settlement agreement and held them to be taxable additions to gross income.⁶⁰

To effectuate such a holding, the *Amos* court had to ensure that the non-excluded proceeds stemming from the consideration paid to Amos for the inclusion of the nonphysical injury provisions were segregated from the excluded proceeds stemming from the physical tort release provisions. The court accomplished this by finding that “Rodman paid petitioner \$120,000 of the settlement amount at issue on account of petitioner’s claimed physical injuries and \$80,000 of that amount on account of the nonphysical injury provisions in the settlement agreement.”⁶¹ Since the settlement agreement did not specify the amount of proceeds stemming from the nonphysical injury provisions, the 120/80 distinction found by the court seemed to be an arbitrary distinction based upon its understanding of the specific case facts.⁶² However, the fact that the distinction was arbitrary does not change the court’s holding that Amos was “entitled under section 104(a)(2) to exclude from his gross income \$120,000 of the settlement amount at issue and [was] required under section 61(a) to include in his gross income \$80,000 of that amount.”⁶³

E. *Consequences of Amos*

Under *Amos*, it appears that confidentiality and cease-prosecution provisions in physical personal injury settlement agreements can be taxable under Federal Rule 61(a) as gross income. As a result, the I.R.S. is likely to view some confidentiality provisions as having a separate nature from the physical personal injury settlement agreements of which they are a part, and thus assess their apportionable settlement proceeds as being taxable as gross income. If a claimant were to appeal such an I.R.S. assessment and the court was to find that the payor’s intent was to pay for secrecy and not for the plaintiff’s personal injuries, the court would likely follow *Amos* in holding the portion of the settlement proceeds attributable to

59. *Amos*, 86 T.C.M. at 664-65.

60. *See id.* at 667.

61. *Id.*

62. *See* USC TAX PLANNING, *supra* note 15, at 1308.2 (stating that in *Amos*, “the Tax Court simply plucked an exclusion percentage out of thin air”).

63. *Amos*, 86 T.C.M. at 667.

268 *HOUSTON BUSINESS AND TAX LAW JOURNAL* [Vol. VI]

confidentiality to be taxable gross income under 61(a) rather than part of the 104(a) exclusion for physical injury and sickness.⁶⁴

Consequently, the commoditization of secrecy could lower the value of a plaintiff's settlement agreement if the plaintiff is not careful to account for the inclusion of confidentiality provisions. It is, of course, the plaintiff who will be held accountable for an unforeseen tax payment on a taxable confidentiality provision, while the defendant pays no additional amount despite acquiring something that is usually of more value to the defendant than to the plaintiff.⁶⁵ The end result of *Amos* is that plaintiffs should be very careful before signing personal injury settlement agreements that include confidentiality provisions and should take legal measures to address the potential tax consequences of these provisions if they are a necessary element of an agreed upon settlement.

IV. SUGGESTIONS TO AVOID POTENTIAL PROBLEMS

A. If Possible, Do Not Agree to the Inclusion of a Confidentiality Provision

Many defense lawyers have a standard form settlement agreement that routinely includes confidentiality provisions. Often, the issue of confidentiality does not even arise until after the plaintiff and defendant have reached a compromise on the main legal issues in the case and the settlement agreement is sent to the plaintiff's lawyer for review. To head off this potential conflict, it is recommended that plaintiffs' attorneys negotiate all cases – whether in writing or verbally – by indicating that no confidentiality provision will be agreed to. Although many defendants might not understand the importance of this precaution, plaintiffs' attorneys can provide defendants with a very reasonable basis under *Amos* for refusing to agree to

64. See generally *id.* at 663-67.

65. See Robert A. Clifford, *Confidentiality May Cost Plaintiffs Plenty in Taxes*, Clifford's Notes, Chicago Lawyer (June 1, 2004), available at <http://www.nfplawsuit.com/news/detail.aspx?identifier=239> (discussing briefly both the *Amos* case and other ethical issues raised by confidentiality provisions).

confidentiality.

B. *Minimize the Confidentiality Component*

If confidentiality provisions are absolutely necessary to procure a settlement agreement, the first step in minimizing the possible adverse tax consequences is to minimize the confidentiality component of the agreement.⁶⁶ “The more prominently featured secrecy is in the settlement agreement, the greater the risk that the secrecy component may yield an IRS assessment.”⁶⁷ In the *Amos* case, the confidentiality provisions represented a substantial part of the settlement agreement by using broad language and constituting four major paragraphs of the agreement.⁶⁸ With the confidentiality provisions playing such an important role in the settlement agreement, the Tax Court had little difficulty attaching a monetary value to those provisions distinct from the value it attached to the personal injury provisions.⁶⁹

In order to avoid this result, plaintiffs should simplify the language of the confidentiality provisions, including as few clauses as are absolutely necessary to reach an agreement, and then integrate those clauses into the personal injury provisions such that the confidentiality clauses do not stand alone. Following these two steps will ensure that the confidentiality provisions are less prominent in the overall scheme of the settlement agreement rather than standing alone in separate paragraph(s) with broad language.

C. *Use Express Language*

When drafting a settlement agreement that includes confidentiality provisions, it is always best to use express language. “[L]anguage in a settlement agreement can offer some probative evidence of how a settlement payment should properly be characterized for purposes of § 104(a)(2).”⁷⁰ Consequently, using express language that eliminates ambiguity will help the plaintiff avoid giving the I.R.S. the opportunity either to engage in an arbitrary determination on bifurcating taxable and

66. Freeman, *supra* note 2, at 10 (discussing taxation as a reason to not sell secrecy as a commodity).

67. *Id.*

68. *Amos*, 86 T.C.M. at 664-65.

69. *See id.* at 667.

70. *Banks v. Comm'r*, 345 F.3d 373, 381 (6th Cir. 2003), *rev'd on other grounds*, 125 S. Ct. 826 (2005) (giving *Bent v. Comm'r*, 87 T.C. 236, 246 (1986), *aff'd*, 835 F.2d 67, 70 (3rd Cir. 1987) as an example).

270 HOUSTON BUSINESS AND TAX LAW JOURNAL [Vol. VI

excludable settlement proceeds⁷¹ or simply to require all proceeds to be allocated as taxable income.⁷² Express language should be used in the following circumstances to eliminate ambiguity:

1. List all Possible Personal Injury Claims

The confidential settlement agreement should expressly set out any and all of the potential physical personal injury claims that the plaintiff may possibly have against the defendant. “[I]t is the nature and character of the claim settled, and not its validity, that determines whether the settlement payment is excludable from gross income under section 104(a)(2).”⁷³ The nature and character of the asserted claim is determined by a factual inquiry.⁷⁴ Consequently, all potential physical injury claims with any sort of a corresponding factual basis should be expressly listed in the settlement agreement. The more physical injury claims the plaintiff expressly lists in the settlement, the greater the opportunity for the plaintiff to persuasively apportion a higher percentage of settlement proceeds to the provisions releasing his or her physical personal injury claims. This in turn effectively decreases the percentage of those proceeds apportionable to confidentiality.

2. Create a Causal Connection Among the Claims, Injuries, and Proceeds

The confidential settlement agreement *should* not only set out all personal injury claims that the plaintiff might have against the defendant, but it should also expressly tie those claims to both the plaintiff’s physical injuries and the settlement amount in order to ensure that the settlement proceeds are

71. See, e.g., *Amos*, 86 T.C.M. at 667.

72. See, e.g., *Shaltz v. Comm’r*, 85 T.C.M. 1489, 1491 (2003). The *Shaltz* court followed the established rule that without any “bona fide language in a settlement agreement as to the reason for the settlement payment, we discern that reason by determining the intent of the payor in making the payment.” *Id.* The petitioner/payee/claimant in *Shaltz* had settled her sexual harassment claims with the defendant, which included the potential physical injury claims of “mental anguish, humiliation, and embarrassment.” *Id.* However, before the *Shaltz* court would accept the claims listed above as being excludable under 104(a)(2), the claimant had to establish the claims as being “physical in nature.” *Id.* at 1491-92. Because the *Shaltz* court failed to find either any bona fide language in the settlement agreement or any evidence establishing the intent of the payor in the record, it refused to attribute any part of the settlement proceeds to the physical injuries alleged by the claimant. *Id.* at 1490-91. As such, none of the proceeds from the claimant’s settlement agreement could be excluded under 104(a)(2). *Id.* at 1491-92.

73. *Amos*, 86 T.C.M. at 666.

74. *Id.*; see *Shaltz*, 85 T.C.M. at 1491.

excludable under 104(a)(2).⁷⁵ “Whether the settlement payment is excludable from gross income under section 104(a)(2) depends on the nature and character of the claim asserted.”⁷⁶ As such, the settlement proceeds should be traceable back to a physical personal injury claim in order to be excluded.⁷⁷ For example, in *Amos*, Amos was able to prove that Rodman’s dominant intent as payor was to compensate Amos for his personal injuries by citing to the portion of the settlement agreement relating to the physical damage claims arising from the Rodman’s kick to the Amos’s groin.⁷⁸ This enabled Amos to create a causal connection between the settlement proceeds and his alleged physical injuries, which helped to partially defeat the I.R.S. Commissioner’s arguments.⁷⁹ Without that provision in the settlement agreement, there is a possibility that all of the proceeds from the settlement agreement might have been considered taxable income under § 61(a).⁸⁰ Thus, *Amos* demonstrates that it is imperative for the plaintiff to expressly set out all possible personal physical injury claims against the defendant and to create a causal connection between the proceeds and those physical injury claims *within the settlement agreement itself*.

3. Expressly Disclaim any Consideration for confidentiality

Any settlement agreement that includes confidentiality provisions should expressly disclaim that any consideration given as a result of the settlement agreement is for confidentiality. In the *Amos* case, multiple confidentiality paragraphs stated that Rodman was giving consideration to Amos not to violate those confidentiality provisions.⁸¹ For example, one provision stated, “It is further understood and agreed that, *as part of the consideration for this Agreement and Release*, the terms of *this*

75. See *Amos*, 86 T.C.M. at 666-67.

76. *Id.* at 666.

77. For cases highlighting the importance of creating a causal connection between the claim, the settlement proceeds, and a physical injury, see *Banks v. Comm’r*, 345 F.3d 373, 375-89 (6th Cir. 2003), *rev’d on other grounds*, 125 S. Ct. 826 (2005) (finding an entire award non-excludable under 104(a)(2) where the only evidence was the plaintiff’s characterization of the award and the plaintiff was thus unable to establish “a causal connection between [the award] and any personal injuries he may have suffered”); *Shaltz*, 85 T.C.M. at 1490-91 (discussed in more detail in note 72 above).

78. *Amos*, 86 T.C.M. at 664, 666.

79. *Id.* at 666.

80. See, e.g., *Banks*, 345 F.3d at 378-79 (discussed in more detail in note 77 above); see also *Shaltz*, 85 T.C.M. at 1491 (discussed in more detail in note 72 above).

81. *Amos*, 86 T.C.M. at 664.

*Agreement and Release shall forever be kept confidential.*⁸² By using such strong language, the *Amos* court really had no other option but to allocate some of the proceeds from the settlement agreement to the petitioner's gross income.

To avoid the same result as *Amos*, it is recommended that plaintiffs' attorneys both check to ensure that the proposed settlement agreement does not expressly tie consideration to its confidentiality provisions and also insert the following sample language at the appropriate place in the agreement: All consideration paid to Plaintiff(s) in this settlement agreement is for physical injuries and sickness suffered by Plaintiff(s) and none of the consideration paid by Defendant(s) is in exchange for confidentiality.⁸³

4. Expressly State the Amount of Consideration Stemming from the Confidentiality Provisions

If the payor is actually paying consideration for the confidentiality provisions, the settlement agreement should expressly state which amount of the settlement proceeds is for the plaintiff's physical injuries and which is for confidentiality. "If the settlement agreement lacks express language stating what the amount paid pursuant to that agreement was to settle, the intent of the payor is critical to [a 104(a)(2)] determination."⁸⁴ In *Amos*, the court found that the settlement agreement did not specify the portion of the proceeds to be allocated to the petitioner's personal injuries or the portion of the proceeds to be allocated for the petitioner's agreement to confidentiality.⁸⁵ As such, the *Amos* court allocated the taxable proceeds from the excluded proceeds based on an unknown—and potentially arbitrary—formula.⁸⁶ The *Amos* court made the division despite the fact that the payor subsequently attested that he paid the money solely to resolve any potential claims that might be had by the petitioner, which were all physical personal injury claims.⁸⁷ To avoid the potential for an unfavorable apportionment or even a complete allocation to gross income, plaintiffs' attorneys should ensure that confidentiality agreements expressly state what

82. *Id.* (emphasis added).

83. See Sidney Gilreath, *Word Revision to Settlement Agreements Could Save Client Taxes*, 41 TENN. B.J. 5, 5 (2005).

84. *Amos*, 86 T.C.M. at 666 (citing *Knuckles v. Comm'r*, 349 F.2d 610, 613 (10th Cir. 1965)).

85. *Id.* at 667.

86. See *id.*

87. *Id.*

percentage of the proceeds is for the plaintiff's claim of physical injuries and what percentage of the proceeds is for the plaintiff's agreement to confidentiality. By so doing, the plaintiff vastly reduces the chance that either the I.R.S. or a tax court will create an arbitrary distinction between taxable and excludable proceeds under the settlement agreement. Of course, plaintiffs should still be advised of the tax consequences associated with this distinction and should be directed to a tax advisor of his or her choice.

5. Expressly Set Out the Payor's Intent

While the tax characterization of a settlement is generally dependent upon the nature of the claim which is paid,⁸⁸ the payor's dominant intent in paying the settlement amount at issue is given great weight by the courts.⁸⁹ In *Amos*, the petitioner used the payor's declaration that the payor entered into the agreement "to resolve any potential claims" as evidence of the payor's dominant intent to pay the petitioner for personal injury claims and not confidentiality.⁹⁰ While the *Amos* court may not have bought the payor's declaration as wholesale evidence of his intent to pay solely for physical personal injuries, the court did use the declaration to validate its conclusion that the payor's dominant purpose was to pay the petitioner for his physical injuries.⁹¹ Consequently, an express statement from the payor indicating that all of the proceeds from the settlement were paid to the plaintiff in order to resolve the physical injury claims the plaintiff did or may have had against the payor should be the very minimum that plaintiffs' attorneys should accept in a settlement agreement. An even better alternative would be an attached affidavit from the payor indicating the same, including the fact that it was the payor's dominant intent to pay the plaintiff only for the personal injury claims and not for any confidentiality. If consideration is actually paid for confidentiality, the statement or affidavit should expressly segregate the amount paid for the plaintiff's physical personal injuries, as opposed to the amount paid for confidentiality.

D. *Require the Defendant to Indemnify the Plaintiff for*

88. *Id.* at 665 (citing *United States v. Burke*, 504 U.S. 229, 237 (1992)).

89. *Id.*; *Shultz*, 85 T.C.M. at 1491 (discussed in more detail in note 72 above); *Fono v. Comm'r*, 79 T.C. 680, 696; *Emerson v. Comm'r*, 85 T.C.M. (CCH) 1043, 1046 (2003) (relying heavily on the testimony of the payor's officers and counsel as to its intent in settling the claim).

90. *Amos*, 86 T.C.M. at 666-67.

91. *Id.*

Adverse Tax Consequences

Because there is very little case law addressing this issue, if the payor is insistent upon including a confidentiality provision in the settlement agreement, the payee should be equally insistent upon the inclusion of an indemnification provision by which the defendant/payor indemnifies the plaintiff/payee for any adverse tax consequences the payee incurs as a result of including the confidentiality provision.⁹² Although plaintiffs' attorneys are likely to be met with resistance because indemnification has typically been a one way street, the *Amos* case should provide ample fodder for legitimately arguing for the inclusion of indemnity protection within the settlement agreement itself.

E. Make a Claim for Physical Injury Early in the Settlement Process

The plaintiff increases the likelihood of exclusion of his or her settlement proceeds pursuant to 104(a)(2) by asserting his or her physical injury claims either before the settlement process begins, which is ideal, or as early in the settlement process as possible. If the plaintiff asserts the claims late in the settlement process, he or she faces a chance that a court could strike down the exclusion and instead allocate the proceeds to gross income because courts have been known to reject claims for exclusions they find "as being motivated solely for tax considerations."⁹³ For example, in *Knoll v. Comm'r*:

[T]he award rose from the taxpayer's termination as a partner of a prominent Chicago law firm. The taxpayer received a settlement after protracted negotiations, in which he never actually voiced any tort claims. Toward the end of the negotiations, on the advice of another similarly dismissed partner, the taxpayer inserted language in the settlement agreement tying his award to alleged emotional

92. See Clifford, *supra* note 65.

93. USC TAX PLANNING, *supra* note 15, at 1308.2 (discussing *Knoll v. Comm'r*, 86 T.C.M. (CCH) 396 (2003)). See, e.g., *Emerson*, 85 T.C.M. at 1045, 1048 (rejecting a 104(a)(2) exclusion claim where the parties to the settlement agreement filed a motion for an agreed dismissal pursuant to the settlement agreement a mere four minutes after the plaintiff's complaint was amended to add the only physical personal injury claim, which was done at the suggestion of the mediator); *Robinson v. Comm'r*, 102 T.C. 116, 128-29 (1994) (rejecting a settlement agreement's characterization of the settlement amount, which allocated 95 percent to mental anguish and 5 percent to lost profits, as "uncontested, non-adversarial, and entirely tax-motivated" and not accurately "reflect[ing] the realities of [the] settlement.").

distress. However, the law firm was never aware of the taxpayer's emotional difficulties, which could also have been brought on by unrelated family issues. As a result, the court rejected the claim for exclusion, as being motivated solely by tax considerations. Telling support for this conclusion was exemplified by the lack of any effort by the taxpayer to establish such a claim with the firm. Since there was no "good faith, adversarial, arm's-length negotiations relating to the personal injury. . .," the law firm's payments could not have been paid to him "on account of" his alleged personal injuries.⁹⁴

Thus, the lesson to be learned from *Knoll* is that the plaintiff should exert his or her claim of physical injury early in the legal process and it should be used as a bargaining chip in the settlement negotiations.⁹⁵

F. *Obtain a Private I.R.S. Ruling*

The plaintiff can also obtain a private I.R.S. ruling based upon his or her specific factual situation and the proposed settlement agreement to determine if the I.R.S. is going to require the plaintiff to allocate some or all of the settlement proceeds to his or her gross income.⁹⁶ If the plaintiff has the time to wait for such a ruling, he or she can make a much more accurate risk assessment and the parties can more accurately distribute the costs of confidentiality.

G. *Remember the Rule Against Compounding and Other Ethical Concerns*

In addition to the tax concerns discussed above, the commoditization of confidentiality is coming to the forefront of legal ethics—not the least of which is the rule against compounding.⁹⁷ The rule against compounding comes into play when a plaintiff is paid for confidentiality regarding a

94. USC TAX PLANNING, *supra* note 15, at 1308.2.

95. The importance of using physical injury as a bargaining chip is shown by the *Robinson* case, in which the court rejected an attempted 104(a)(2) exclusion that it saw as being added to the settlement agreement in an "uncontested, non-adversarial, and entirely tax-motivated" manner. *Robinson*, 102 T.C. at 128-29 (discussed in more detail in note 93 above).

96. See Clifford, *supra* note 65.

97. Freeman, *supra* note 2, at 9.

276 HOUSTON BUSINESS AND TAX LAW JOURNAL [Vol. VI

defendant's illegal conduct.⁹⁸ There is currently a statutory movement to make settlement agreements containing compounding provisions unenforceable as a matter of law and to impose criminal sanctions on the attorneys who create them.⁹⁹ While there is currently no statute invalidating compounding in many states, including Texas, there is case law to the same effect.¹⁰⁰ For example, the Texas family court case *In Re Kasschau* is discussed by John Freeman:

In *Kasschau* the parties settled their marital dispute at a mediation with a term of settlement calling for destruction of tape recordings and transcripts of the wife's conversations. The conversations had been taped illegally. This provision violated a Texas statute criminalizing the destruction of evidence. Rather than just striking the offending provision, the trial court threw out the entire settlement. The appellate court refused mandamus relief, saying:

We recognize that there are competing public policy interests at stake here. On the one hand, courts are responsible for carrying out this state's policy of encouraging the peaceable resolution of disputes involving the parent-child relationship through voluntary settlement procedures. . . On the other hand, public policy prohibits courts from enforcing illegal contracts. Here, we are unable to find the trial court violated the public policy encouraging settlements by refusing to enforce a settlement agreement that it found contained an illegal provision.¹⁰¹

While *Kasschau* was a family settlement agreement and not one involving personal injury,¹⁰² the concept remains the same: the law is increasingly frowning upon confidentiality provisions that either allow the payor or payee to engage in illegal conduct to

98. *Id.*

99. *Id.* (discussing South Carolina's compounding statute and its criminal punishment for its violation); Clifford, *supra* note 65 (noting that "more than a half dozen states have considered legislation that would ban confidential settlements in cases that compromised public safety"); Laurie K. Dore, *Settlement, Secrecy, and Judicial Discretion: South Carolina's New Rules Governing the Sealing of Settlements*, 55 S.C. L. REV. 791, 792-93 (2004); Richard A. Zitrin, *The Laudable South Carolina Court Rules Must be Broadened*, 55 S.C. L. REV. 883, 884 (2004).

100. *See, e.g., In re Kasschau*, 11 S.W.3d 305, 312-13 (Tex. App.—Houston [14th Dist.] 1999, no pet.).

101. Freeman, *supra* note 2, at 9.

102. *Kasschau*, 11 S.W.3d at 308.

maintain secrecy or allow a payor to keep his or her illegal conduct silent.

Moreover, even confidential settlement agreements that are not *per se* illegal under the rule of compounding are starting to be subjected to moral and legal public policy questions regarding their validity and enforcement.¹⁰³ This growing ethical disfavor is likely a result of the backlash stemming from the string of recent confidentiality abuses taking place in settlement agreements. These confidentiality abuses have created public policy issues because they are reflective of cases in which the information obtained in the underlying claim or litigation would, if not otherwise kept secret by the confidentiality agreement, benefit the public good. An obvious example of this would be the Ford Explorer/Firestone controversy in which it appears that accidents were being caused by the continuing use of either defective tires, a defective vehicle, or a combination of both resulting in hundreds – if not thousands – of personal injuries and deaths.¹⁰⁴ Thus, plaintiff's attorneys should pause and think before entering into a confidentiality agreement when either public safety or policy would dictate otherwise.

H. *Consider Demanding Extra Money for the Inclusion of a Confidentiality Provision*

As discussed above, the inclusion of a confidentiality provision in an otherwise valid settlement agreement brings with it unresolved tax and ethical problems. Consequently, if the defendant demands insertion of a confidentiality provision into the settlement agreement, the plaintiff should consider demanding extra compensation for its inclusion—in addition to the other safeguards discussed above. The amount of extra compensation an individual plaintiff should demand should be based upon his or her attorney's evaluation of the risk inherent in the inclusion of the confidentiality provision. Evaluating that risk will likely involve analyzing a combination of factors, including the type of injuries involved, the type of conduct the payor wants to keep secret, the receptiveness of the payor to including safeguards, and the financial situation of each individual plaintiff and defendant. However, before using the results of a plaintiff's risk evaluation to obtain additional compensation for confidentiality, it is of the utmost importance for plaintiffs' attorneys to stop and again carefully consider the

103. See Dana & Koniak, *supra* note 5, at 1217-18 (arguing for ethical and legal rules prohibiting confidentiality provisions in settlement contracts).

104. Clifford, *supra* note 65.

278 *HOUSTON BUSINESS AND TAX LAW JOURNAL* [Vol. VI]

ethical and legal ramifications of selling secrecy as a commodity and to then also counsel his or her client about the same, so that an informed decision can be reached.

V. CONCLUSION

Millions of television viewers witnessed Dennis Rodman kick Eugene Amos in the groin on January 15, 1997 at a basketball game between the Minnesota Timberwolves and the Chicago Bulls.¹⁰⁵ Many legal observers likely assumed Rodman paid Amos a confidential amount of money in order to resolve the litigation entirely. And while lawyers all over this country assumed that that was the end of the Rodman/Amos litigation, few even today know that the outcome could affect their practice on a daily basis.

The fact of the matter is that confidentiality provisions are more common now than ever. As such, unless plaintiffs' lawyers take precautions to protect their clients from the potentially adverse tax consequences that come with the inclusion of confidentiality provisions in settlement agreements, a whole new cottage industry of legal malpractice may be developing because of the liability exposure for both the client and the lawyer. To avoid this result, plaintiffs' attorneys should both incorporate the safeguards recommended in this article into their daily practices and continue to educate themselves about the potential consequences of entering into a confidential personal injury settlement agreement.

105. *Amos v. Comm'r*, 86 T.C.M. (CCH) 663, 663 (2003).