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MCLE

Tax consequences of confidentiality and non-disparagement clauses in personal injury cases in the mediation context: a practicum

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Mediation has become a staple of civil litigation. The Uniform Mediation Act broadly defines “mediation” to mean any “process in which a mediator facilitates communications and negotiation between parties to assist them in reaching a voluntary agreement regarding their dispute.” (Uniform Mediation Act § 2(1).) Thus, the goal of mediation in most cases is to resolve the matter brought to the mediator by the parties. There are considerations that the mediator must take into account in the leadup to that goal, on behalf of the parties, and to avoid a potential claim of malpractice against the mediator (as well as counsel). Legal malpractice by plaintiff’s counsel in failing to appropriately address the value of such clauses in a settlement agreement would appear to be self-evident. Less evident is mediator liability. But in any event, it’s bad for business for the lawyer and the mediator not sensitive to the issue. This article is intended to sensitize the mediator and counsel to the real tax consequences that may accrue if a confidentiality clause is obtained in the settlement agreement, without allocating value to it.

Generally, a confidentiality clause seeks to prohibit the parties to a settlement from disclosing the settlement terms and sometimes more. Non-disparagement, by its terms, compels the settling plaintiff to refrain from negative comments regarding the defendant(s). For the sake of brevity, this article will address both under the same term: confidentiality.

This article will focus on the topic of tort (physical injury, and sickness claims) mediation as well as confidentiality and non-disparagement clauses that are seeming afterthoughts at the conclusion of a mediation. Critically, they should not be afterthoughts; the mediator should understand the implication of such clauses and the tax effects on



The Treasury Department in Washington on Friday, Dec. 17, 2021. | New York Times News Service

the settling plaintiff(s). The author does not endeavor to assess the inherent benefit or detriment of such clauses, merely the considerations mediators and counsel should

rejection of the late-suggested clause just as the case is about to resolve may invariably scuttle the settlement, or result in a demand for additional remuneration, and potentially

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employ in addressing such in the context of settling cases. Oftentimes, confidentiality as a term of the settlement arises just as the case is resolving and the parties have reached agreement as to the monies to be paid, with (usually) defense counsel saying, “Oh, and my client requires a confidentiality and non-disparagement clause.” Up until that point, it is not a twinkle in the mediation, but it ought to have been addressed or at least considered at the outset by the mediator as a good practice and discussed upfront with the parties. Oftentimes, a plaintiff’s

make meaningless a day or more of expensive mediation.

[PRACTICE NOTE] **Including a confidentiality clause in a settlement agreement could potentially subject an otherwise non-taxable settlement to federal income tax.** Federal income tax rules provide a sweeping definition of “gross income,” from which individuals are required to calculate their taxable income. The Internal Revenue Code defines “gross income” as including “all income, from whatever source derived.” (26 USC § 61(a).) The Supreme Court of the United States

has repeatedly emphasized the sweeping scope of this definition. Adding to the sweeping language of 61(a), Supreme Court decisions require that “exclusions from gross income must be narrowly construed.” (*Comm’r v. Schleier*, 515 U.S. 323, 328 (1995).) Settlement proceeds are excluded from the reach of 61(a) by 26 U.S.C. § 104(a). Section 104(a) provides an exclusion for five categories, “compensation for personal injuries or sickness.” Section 104(a) (2) provides a narrow exclusion from “gross income” that is applicable for damages received on account of personal physical injuries or sickness. 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.” The regulations under 104(a) (2) clarify this point: “The term ‘damages received (whether by suit or agree-

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ment)' 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." 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)."

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*. The first prong of the Schleier test requires the award to be "based upon tort or tort-type rights," while the second prong requires that the award be paid "on account of [physical] personal injuries or [physical] sickness." 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. In the seminal case of *Amos v. Comm'r*, 86 T.C.M. (CCH) 663, 665-66 (2003), the court noted that whether or not the two prongs of the Schleier test are met depends on how the settlement proceeds are characterized for tax purposes. 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. 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." Although certainly relevant, "self-serving statements or beliefs by the plaintiff are often discounted if not corroborated by other evidence." (*Amos*, 86 T.C.M. at 666.) In sum, however, the Amos court noted that 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." (*Amos*, 86 T.C.M. at 664.)

The genesis of *Amos* is an NBA basketball game in which Dennis Rodman was a player for the Chicago Bulls. Rodman fell onto some photographers during a game against the Minnesota Timberwolves on January 15, 1997. While getting up, he kicked photographer Eugene Amos in the groin, allegedly causing him physical injuries. 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 at Hennepin County Medical Center. As the facts played out, medical personnel did not notice any signs of trauma to Amos other than a limp and his complaints of pain. Between various

hospital visits, Amos obtained a lawyer and filed a police report with the Minneapolis Police Department claiming Rodman had assaulted him. Thereafter, Rodman's attorney contacted Amos' attorney, and they negotiated a confidential settlement/release agreement for \$200,000. The dispute in the tax court between Amos and the IRS centered on each party's conflicting view on how much of the settlement proceeds were entitled to be excluded from Amos' gross income under 104(a)(2). The IRS contended that only a nominal amount of the settlement proceeds could be legally excluded, while Amos asserted that the entire \$200,000 should be legally excluded. Consequently, it was necessary for the United States Tax Court to decide whether the settlement proceeds could be legally excluded from Amos' gross income and, if so, what percentage, if not the entire amount, could be properly excluded. The reader is urged to read the opinion for a full explanation of the facts and issues. Suffice it to say, 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. In 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." In rejecting *Amos's* claim, the court specifically relied on the language of the confidentiality provisions in the settlement agreement, the relevant portions of which were 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 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.

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)." 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 sickness." Thus, 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.

Commodification 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 invariably 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 generally of more value to the defendant than to the plaintiff. The upshot 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. Of course, the mediator must be cognizant of these concerns in shepherding a settlement.

To effectuate provisions as separate commodities within the settlement as taxable additions to gross income, 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 did 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." 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. Nonetheless, 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." At the very least, the mediator may suggest that specification of an amount for the confidentiality clause would be a wise practice.

[PRACTICE NOTE] **If you perceive this is a case that might engender a confidentiality clause request, address it upfront with defense counsel in your pre-mediation session or privately at the mediation.**

The mediator must be cognizant that if confidentiality is an unavoidable material term of the settlement, he or she must comprehend the implications to the settling plaintiff. For example, plaintiff's counsel may minimize tax consequences by (1) obtaining mutuality in a bid to show the clause has value to both sides and (2) allocating adequate (but low) value to the clause in the settlement. (See Robert A. Clifford, "Confidentiality May Cost Plaintiffs Plenty in Taxes," Clifford's Notes, Chicago Lawyer (June 1, 2004).)

Confidentiality provisions are increasingly common in personal injury cases. Plaintiffs' lawyers must take precautions to protect their clients from the potentially adverse tax consequences that come with the inclusion of confidentiality provisions in settlement agreements, including those reached in mediation. Counsel should address such concerns with the mediator upfront and endeavor to establish a modest value to the secrecy provision. Failing to do so exposes the practitioner to legal malpractice claims.