Paying the Piper: Executives and Legal Fees

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When an executive faces legal action and incurs legal fees for conduct arising out of his employment, should the company pay the fees? Most executives would answer yes. Historically, most companies have also answered yes. Yet, many members of the general public would probably answer no. Indeed, in this post-Sarbanes-Oxley world, whether to foot the bill for an executive’s legal fees (or pay them directly) can prove to be an increasingly close call. And, if the call is made to reimburse the executive, there can be legal and tax consequences.

A recent example involves Merrill Lynch and Daniel Bayly, Merrill’s former investment banking chief. Bayly and three other Merrill executives were indicted and tried for fraud over Merrill’s role in a Nigerian barge transaction with none other than Enron. Do you find it hard to imagine a transaction involving a Nigerian barge and Enron smacking of anything criminal? Well, the government had no trouble imagining it. In fact, prosecutors not only imagined the criminal activity, but had no trouble proving it. The four Merrill executives were convicted.

Not only that, but the Merrill executives’ unsuccessful criminal defense came at a significant price. By the time they were convicted, Bayly and the other three defendants had racked up a whopping $17 million legal bill. Merrill had been paying the legal bills, but bearing that cost, particularly in the face of the executives’ conviction, may cause problems for Merrill as well as for the executives.

The proper treatment of legal fees arising out of an investigation into or involving executives (especially a criminal prosecution) raises tax concerns too. Convictions clearly heighten those concerns. Some experts say a conviction makes the company’s payment of the legal fees entirely inappropriate. So says Charles Elson of the John L. Weinberg Center for Corporate Governance at the University of Delaware. Ditto for Lawrence Hamermesh, professor at Widener School of Law in Delaware.

A conviction is not the only factor altering the appropriateness of reimbursement. Some commentators also argue that the financial wherewithal of the defendant/executive should play a part in the appropriateness of the reimbursement. Bayly reportedly has a personal net worth of around $60 million. Perhaps that makes him less deserving than an executive who has departed the company with only the proverbial gold watch. Perhaps that makes Tyco's Dennis Koslowski the least likely to merit reimbursement.

The company’s bylaws can also be relevant to the reimbursement issue. Corporate bylaws often say something about the company bearing the cost of legal fees for company business. Merrill’s bylaws call for paying employee legal bills until there is a “final disposition” of the case. Despite that seemingly bright line, Merrill’s bylaws do not define a “final disposition.” A final disposition may mean a conviction or acquittal, or perhaps the conclusion of all possible appeals. There does not seem to be a generally accepted definition of final disposition.
Employment contracts can raise similar issues. The recently acquitted Richard Scrushy thinks that under the terms of his employment agreement, HealthSouth has to pay his legal fees. HealthSouth’s board disagrees, noting that it voided Scrushy’s employment contract over two years ago in March 2003.

State law can also play a role in determining the appropriateness of reimbursement. For example, Delaware law does not condition the appropriateness of the legal fee reimbursement on the lack of a conviction. Under Delaware law, a conviction would not automatically require the company to seek reimbursement from the executive for any fees the company had paid. While a conviction would indicate guilt or innocence in the eyes of the court, a conviction would not by itself create the presumption that a person did not act in good faith and in a manner the person reasonably believed to be in the company’s best interests.

Delaware enacted its law to encourage capable persons to serve as officers, directors, and employees of Delaware corporations. The idea is that assuring those persons that their reasonable legal expenses would be borne by the corporations they serve makes them much more willing to stick their necks out and serve. In fact, Delaware law does not require complete success but instead provides for indemnification to the extent of success in defense of any claim, issue, or matter in an action.

Nature of the Expense

Regardless of whether the employee is convicted or acquitted, or even if the legal expenses arise out of something much less serious, one reasonable line-drawing criterion is the nature of the legal expense. Legal expenses can arise in quite different circumstances. Consider the following categories of legal expenses:

- those that are purely personal;
- those that relate to personal conduct, but regarding which the company reasonably believes its business is affected;
- those arising from the executive’s conduct that is not authorized but that is related to his job (for example, sexual harassment);
- those arising out of corporate conduct in which the executive had a role; and
- those arising out of corporate conduct in which the executive did not have a role.

First and easiest to dispose of are legal expenses of a purely personal nature (for example, legal fees related to the executive’s divorce). Any reimbursement of legal costs of that nature would be additional compensation to the executive. Such a reimbursement would be deductible by the company assuming it, together with all of the rest of the executive’s compensation, is “reasonable” and does not run afoul of the $1 million deduction limit of section 162(m).

Next in the hierarchy would be legal fees related to a personal matter of the executive that the company reasonably thinks could affect its business. For example, suppose an executive is on trial for shoplifting. The executive’s legal fees clearly relate to a strictly personal matter. However, the company might reasonably be concerned that a shoplifting conviction for the executive could affect its own business. Therefore, the company might determine to pay all or a portion of the executive’s legal fees not with compensatory motive, but rather to preserve and enhance its own business and company reputation. How
credible is the argument that the company can deduct the payment and that there is no income to the executive?

In Peters, Gamm, West, & Vincent Inc. v. Commissioner, a
individual investment adviser was sued by the Securities and Exchange Commission for his activities at a particular brokerage firm. In the interim, he changed jobs. By the time the matter was settled with the SEC, his new employer paid the settlement to the SEC. The IRS disallowed the deductions claimed by the new employer. In the Tax Court, the new employer argued that it needed to settle the matter because a finding against the individual would seriously damage the new company's business reputation. The Tax Court nevertheless concluded that the fees were not deductible because they were not directly connected with the business.

Next, consider legal expenses arising out of an investigation of the executive’s actions for the company, when the executive’s activities arguably do not fall within the course and scope of employment. A good example would be sexual harassment allegations involving the executive and one or more employees. Most companies don’t have a problem reimbursing an executive for legal expenses in that situation. Even though it is clearly not in the executive’s job description to harass employees, allegations of that sort can arise out of any employment situation. If the company pays the legal fees, it should be able to claim a deduction for them.

For example, in Clark v. Commissioner, the taxpayer was entitled to deduct all legal fees associated with defending and settling a claim of sexual assault. In that case, a branch manager, whose duties included interviewing applicants for positions with the company, was accused of sexual assault. Because the alleged activity proximately resulted from the branch manager’s duties in the course of his employment (interviewing a female applicant), the Tax Court allowed the taxpayer to deduct the legal expenses related to the dispute.

In contrast, the Tax Court disallowed deductions in connection with a sexual assault prosecution when it found that the activity did not have a for-profit nexus. In Kelly v. Commissioner, the dispute arose from the interaction of a male employee with a woman after work. Interestingly, the Tax Court declined to find a business connection regardless of the fact that the man’s employment gave him access to a hotel room where the alleged sexual assault occurred.

Finally, we should address legal expenses arising out of corporate conduct. I see this as splitting into two separate subjects depending on the nature of the investigation. The first of those two circumstances might involve an investigation into the executive’s conduct of specific activities, such as negotiating a deal for the company. I’d call that an investigation of the executive expressly related to the company’s business. Second, an executive might incur legal expenses when he is not even remotely involved in the business being investigated, and yet he incurs legal expenses merely by his association with the company. I’d call that an investigation into the company, into which the executive is necessarily drawn. An investigation into a division having nothing to do with the executive, for example, would seem to fall into the final category.

When to Reimburse, When Not?

The executive’s legal expenses paid in both of those situations are normally regarded as corporate expenses, and there is clearly no compensating purpose. However, the latter cases (in which the executive’s conduct is not in question at all) are the easiest to resolve. While payments in both cases should be deductible by the company, cases of the former variety (for example, when the executive’s
conduct within the course and scope of his employment is ultimately found to be unlawful) can raise both tax and corporate problems.

Against the background of those myriad types of factual situations, and the necessity of handling the executive’s legal fees in all of them, one can also develop a hierarchy of the equitable arguments for reimbursement. The equitable arguments for the appropriateness of reimbursement may bear a relationship to the appropriateness of tax deductions for the company’s payment of the legal fees.

For example, if an executive pays or incurs legal fees because of an investigation of the company, I think there is a stronger case for reimbursing the executive than if it was the executive’s own conduct that caused the investigation. If the executive’s conduct is being investigated (such as in a criminal prosecution of the executive), the executive has a less persuasive argument that the company should bear the fees, particularly if the conduct is unrelated to the business of the company.

Often, such neat line-drawing exercises are not possible. In the case of Bayly and Merrill Lynch, the Nigerian barge transaction was already the subject of an SEC investigation and complaint. In fact, Merrill had paid $80 million to settle an SEC complaint charging that Merrill helped Enron commit fraud in the deal. Merrill also settled with the Justice Department to avoid indictment. Some of Merrill’s former leading employees, including Bayly, were indicted on charges of conspiracy to commit wire fraud and falsify books and records. One of the executives was also charged with perjury and obstructing a federal investigation into Enron. However, Merrill Lynch accepted responsibility for the conduct of its employees and agreed to cooperate fully with the continuing Enron investigation. Merrill implemented a series of sweeping reforms addressing the integrity of client and third-party transactions. The overlap between executive conduct and company responsibility is readily apparent.

Another recent example involves embattled insurance giant American International Group Inc. (AIG), which recently promised to pay the legal bills of most of its directors. Agreements were made with 13 of AIG’s 18 directors, entitling the directors to costs incurred because of legal actions stemming from their membership on AIG’s board. Notably, AIG’s agreements with its directors do not include the inside directors (that is, the AIG executives on the board). They also do not include Maurice R. “Hank” Greenberg (former chairman and chief executive officer) or Howard I. Smith, who was fired as chief financial officer. In AIG’s situation, state and federal authorities are investigating whether AIG used improper accounting in recent years to polish its financial results and mislead shareholders.

**Effect on Investigation**

Whether a company pays executives’ legal bills can affect the duration and security of the investigation. According to Justice Department guidelines, the payment of attorney fees on behalf of an employee or agent can be relevant in determining the extent and value of an organization’s cooperation with the government. If an organization pays attorney fees on behalf of its officers and directors (or even its rank-and-file employees), that organization may be subject to more stringent prosecution by the government.

That should tell you there are more than mere tax considerations involved here. The connection between fees and the severity of an investigation clearly can influence organizations that are under investigation for potential wrongdoing. Indeed, self-interest should make the company less inclined to reimburse its executives for legal
fees. If paying the executives brings more scrutiny, the sting of payment can be quite severe.

Requirements for Deducting Legal Fees

The Internal Revenue Code does not expressly provide for a deduction for legal fees. Instead, legal fees arising from a trade or business are generally deductible under the general business expense provision of section 162. If the activity does not rise to the level of a trade or business, it still may be deductible under section 212 as an activity engaged in for profit. The latter allows for deductions related to the production of income or investment activities, activities that have a profit motive but are something less than a full-blown business.

To be deductible under section 162 or 212, legal fees must be ordinary, necessary, and reasonable. Plus, they must be directly connected (or proximately result from) the taxpayer’s trade or business (or in the case of section 212, the taxpayer’s investment activity). The “ordinary and necessary” requirement has generated substantial confusion over the years, though it seems awfully pedestrian.

Generally speaking, an expense (for legal fees or otherwise) is ordinary if a business person would commonly incur it in the particular circumstances involved. Taxpayers frequently confuse the “ordinary” requirement with the notion that the particular expense must arise over and over again, and hence would be ordinary in the common usage of that word. Taxpayers generally think of the ordinary requirement as synonymous with recurrent.

However, the courts have been much more expansive in their interpretation of the ordinary and necessary requirement. The Supreme Court has noted that an ordinary expense of a particular nature may be extremely irregular in occurrence, stating:

A lawsuit effecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. Nevertheless, the expense is an ordinary one, because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack.

Moreover, the Tax Court has noted that the employment of an attorney satisfies the ordinary requirement if it is consistent with the behavior of a reasonably prudent man in the same circumstances. One might only rarely during the life of a business need to resort to hiring an attorney.

Just as the ordinary requirement has been liberally interpreted, so has the “necessary” requirement. It is not necessary to inquire whether the taxpayer really had to incur a particular expense, such as paying the legal fees of an employee or agent of the organization, if incurring such an expense is “appropriate or helpful” to the business. Given the authorities, the word “appropriate” or “helpful” might be more apropos than “necessary.”

The ordinary and necessary nature of the payment of legal fees in this context is rarely questioned (by the IRS or by the judiciary), assuming the requisite nexus can be established between the lawsuit and the business of the defendant. There is still the question of the overall “reasonableness” of an expense. The reasonableness of a payment in this context (under either a settlement or judgment) will generally not be questioned. Because litigation is by its very nature adversarial, the reasonableness of a payment to dispose of litigation is rarely questioned.
Corporate Business and Benefit

For legal fees to be deductible by an organization, they must generally be directly connected to its trade or business. Nonetheless, the deduction of legal fees is not dependent on the success of the case. Instead, the deductibility of legal fees is determined under the origin of the claim doctrine. The origin of the claim doctrine enunciates that "the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was 'business' or 'personal' and hence whether it is deductible or not."

The most well-known "origin" case is Raytheon Production Corp. v. Commissioner, 144 F.2d 110 (1st Cir. 1944), cert. denied 323 U.S. 779 (1944). There, the Supreme Court expressly asked "In lieu of what were the damages awarded?" thus inviting discussion of the origin and nature of the claim. One can see the same origin inquiry on the deduction side too. For example, in United States v. Gilmore, the expenses of divorce litigation were held to be nondeductible personal expenditures, even though an adverse decision in the matter was likely to destroy the taxpayer's business. The origin of the claim was the divorce litigation, not the potential consequences of the divorce to the business, however adverse those might turn out to be. Thus, the litigation expenses were nondeductible personal expenditures.

Closely related to the origin of a claim is the identity of the payer. Only the payer is entitled to potentially applicable deductions. If a corporation deducts legal fees arising out of the actions of its agents, equity holders, or employees, the appropriateness of those deductions may be questioned.

Technically, to be deductible, the organization must pay or incur the amount for its own benefit, rather than for the benefit of others. Legal fees and expenses relating to the actions of officers and directors in conducting a corporation's business have generally been held deductible by the paying corporation on the theory that the matter is proximately related to the business of the corporation and the results achieved in litigation are beneficial to the corporation. Nonetheless, corporations have been denied deductions for legal expenses incurred in defending suits against employees that are unrelated to the company's trade or business.

When the employee is a major equity holder in the organization, it may be best to avoid that type of situation altogether. One way of doing so is to have the individual make a contribution to capital to the organization for the amount of his legal fees. That contribution is generally tax-free under section 118, 351, or 721. The organization can then use the amount contributed to pay the legal fees, and that amount can be deducted by the organization as an ordinary and necessary business expense. Of course, the individual is unlikely to find that approach remotely attractive unless he owns 100 percent of the company.

Fines and Penalties

If the legal fees relate to the imposition of a fine or similar penalty, additional considerations apply. Payments of legal fees or settlements and judgments are generally deductible if made in the ordinary course of a trade or business. Payments made in the production of income or in furtherance of investment activities are also generally deductible. In contrast, the code expressly prohibits a deduction for "any fine or similar penalty paid to a government for the violation of any law." Attorney fees incurred in defending against the imposition of
fines or penalties have also been held to be nondeductible on the theory that they are tainted by the nature of the litigation.\(^{26}\)

Section 162(f) denies a deduction for both criminal and civil penalties, as well as for sums paid in settlement of a potential liability for a fine or penalty.\(^{27}\) It is the latter element of the provision that often causes controversy. It may (or may not) be clear that a fine is likely to be imposed when a potential liability is satisfied.

In some cases, whether a payment falls within the prohibited category of a fine or similar penalty may depend on the intent of the perpetrator. If the fine or penalty is in fact imposed, the denial of the deduction is absolute. It does not matter whether the violation of law was intentional or unintentional. No deduction will be permitted for the payment of a fine or similar penalty even if the violation is inadvertent and even if the taxpayer must violate the law to operate profitably.\(^{28}\)

The magnitude of the issues can be staggering. For example, roughly $1.5 billion was shelled out by the securities industry in 2003 for its indiscretions.\(^{29}\) Interestingly, of that amount, only about $450 million was characterized as nondeductible fines or penalties.\(^{30}\) That indicates a key point about all of this from a payer’s perspective. There is often wiggle room in characterizing the nature of the payment. That is nothing new.

Indeed, Exxon was almost as fortunate as the securities industry players when paying for its Exxon Valdez oil spill catastrophe. The U.S. government’s $1.1 billion settlement with Exxon actually cost Exxon a mere $524 million on an after-tax basis. The Congressional Research Service determined that more than half of the civil damages -- totaling $900 million -- could be deducted on Exxon’s federal income tax returns.\(^{31}\)

Frequently, the line-drawing exercises that take place are imprecise. It is axiomatic that fines and similar penalties, as well as their corresponding legal fees, are nondeductible under section 162(f). Yet, it is often not so easy to tell if a payment is a fine or similar penalty, and that classification issue is key.

### AMT Implications

If an individual is deducting his own legal expenses, it is worth noting one large potential pitfall. There are many similarities between deducting legal fees as business expenses under section 162 and deducting them as investment expenses under section 212. Yet, there is one big difference -- the alternative minimum tax. Legal fees deducted under section 212 are not deductible for AMT purposes.\(^{32}\) Legal fees taken as miscellaneous itemized deductions are also subject to a floor of 2 percent of adjusted gross income and are phased out for high-income taxpayers.\(^{33}\)

For example, assume John is indicted on multiple counts of racketeering, conspiracy, extortion, fraud, and obstruction of justice. Assume further that John’s various income-producing activities constitute activities engaged in for the production of income. Accordingly, John’s legal fees ($500,000) may be deducted only under section 212 (instead of section 162), and will be entirely nondeductible for AMT purposes. During the year of his indictment, John had been quite successful in producing substantial income ($500,000) from his various activities. At trial, John pleads not guilty, claiming that he is a law-abiding businessman. The jury is not convinced, and convicts John on multiple counts of racketeering.
On his tax return, John deducts his attorney fees under section 212. Those fees are subject to the usual rules for miscellaneous itemized deductions (the 2 percent floor and phaseout). Furthermore, because the deduction is disallowed entirely for AMT purposes, John ends up owing roughly $136,000 in federal income taxes (even though he had deductions equal to or greater than his income). Of that amount, over 98 percent results from application of the AMT. Had John instead been able to claim a business expense deduction for the fees under section 162, his tax liability for the year would have been about $1,000.

Income to the Executive?

One of the most frightening aspects of those rules for executives is that, after being relieved that the company is picking up the tab for their legal fees, they may find themselves deemed to have additional taxable income by virtue of receiving that benefit. The executive may face latent tax problems when a company pays or reimburses his legal fees. Normally, employees treat reimbursed business expenses as a wash, claiming no deduction for the fees and no income on receipt of the reimbursement. Similarly, if the executive never goes out of pocket (and the company simply pays the fees), most executives would never consider that they might have income measured by the amount of the legal fees.

Yet, sometimes income does arise in that circumstance. In O’Malley v. Commissioner,” the Tax Court found a pension fund trustee to be in receipt of gross income when his employer paid his legal fees in a criminal prosecution for conspiracy to commit bribery. That kind of quandary happens more than you might think.

At trial, O’Malley argued that the legal fees were ordinary and necessary business expenses of his employer (not him), and, accordingly, that they should not be included in his gross income.

However, in large part because the pension fund (his employer) was not named as a defendant in the prosecution, the Tax Court determined that the expenses were not ordinary and necessary business expenses of the organization.” Instead, the Tax Court found that the legal fees were personal to O’Malley. The Tax Court determined that the payment of O’Malley’s personal legal fees by the pension fund was income to him. The court relied on Old Colony Trust. Even so, the Tax Court permitted O’Malley to deduct those legal fees as ordinary and necessary employee business expenses.

Conclusion

The determination of whether a company should ultimately pay for the legal costs incurred by one of its executives is one that must take into account several factors, including the nature of the litigation, how closely the litigation relates to the executive’s scope of duties, and whether the company can properly deduct those costs. In light of recent activity, that decision must also encompass the effect the payment or reimbursement will have on any ongoing investigation and the amount of legal costs actually incurred in defending the executives.

The amount, nature, and complexity of executive lawsuits today have reached a level unparalleled. If a company is going to absorb the cost of defending an executive in an investigation (or even an indictment) it should seriously consider not only the legal and public relations ramifications, but also whether those costs will be deductible.

2 Id.


4 Id.

5 8 Del.C. section 145(a).


7 See T.C. Memo. 1996-186, Doc 96-11603, 96 TNT 77-8.

8 30 T.C. 1330 (1958).


12 See Commissioner v. Chicago Dock and Canal Co., 84 F.2d 288 (7th Cir. 1936); see also Commissioner v. Heininger, 320 U.S. 467 (1944).


14 Kanelos v. Commissioner, 2 T.C.M. 806, 808 (1943).

15 See Lilly v. Commissioner, 343 U.S. 90 (1952).

16 In the case of deductions under section 212, the requisite nexus between the income-producing activities or investment activities of the taxpayer must be between the litigation and the taxpayer’s income-producing or investment activities.

17 Michaels v. Commissioner, 12 T.C. 17 (1949), acq. 1949-1 C.B. 3; Harvey v. Commissioner, 171 F.2d 952 (9th Cir. 1949).


22 See Ecco High Frequency Corp. v. Commissioner, 167 F.2d 583 (2d Cir. 1948), cert. denied 335 U.S. 825 (1948). See also Jack’s Maintenance Contractors Inc. v. Commissioner, 703 F.2d 154 (5th Cir. 1983).


25 Section 162(f). Compare with section 162(a).

26 See Burroughs Building Material Co. v. Commissioner, 47 F.2d 178 (2d Cir. 1931); see also Allied-Signal Inc. v. Commissioner, T.C. Memo. 1992-204, Doc 92-2903, 92 TNT 74-10, aff’d 54 F.3d 767, Doc 95-2752, 95 TNT 47-8 (3d Cir. 1995).

27 Reg. section 1.162-21(b).


32 Section 56(b)(1)(A)(I).

33 See sections 67(a) and 68(a).


36 See Matula v. Commissioner, 40 T.C. 914, 920 (1963); Sachs v. Commissioner, 32 T.C. 815, 820 (1959), aff’d 277 F.2d 879 (8th Cir. 1960).

37 279 U.S. 716 (1929).