Legal Opinion Letter

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FEDERAL GOVERNMENT BAILOUT FOR TRIAL LAWYERS

by
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We have all heard of federal bailouts for our insurance companies, automobile companies, and even banks, but very few realize that buried in a deep silo on Capitol Hill is a proposal which, as a practical matter, would be a bailout for trial lawyers. The bill, introduced by Senator Arlen Specter and co-sponsored by Senators Graham, Leahy, Wyden, Crapo, Martinez, and Landrieu, would amend the Internal Revenue Code of 1986 to allow personal injury lawyers to deduct "loans" made to clients at the time the loans are made, not as is in the case under current law, in the future if and when, at the end of the litigation, the loans are not repaid.

Background: An astute minister, Albert Sikkelee, once observed in the context of a sermon, "something not in context is pretext." These words of wisdom apply in this precise situation with respect to plaintiffs' lawyers' attempt to change the Internal Revenue Code. In most states, plaintiffs' lawyers are not allowed to advance expenses for their clients. Ethics Committees may scrutinize lawyers if the expenses they advance are substantially large. In common law terms this is called "champerty," whereby the attorney, not the client, is the driving force in the litigation.

To circumvent champerty rules, a tradition arose a long time ago for a plaintiffs' lawyer to make a "loan" to the client. The loan would cover all major expenses. If the plaintiff won the case under what is called a net fee contingency contract, the cost of that loan plus a modest amount of interest would be added to the fee. That is one reason why we sometimes see situations where clients may get even less than 50% of the final award.

Thirty years ago, trial costs were relatively modest. But today, if a plaintiffs' attorney wishes to pursue a major case, particularly against a pharmaceutical, insurance, automobile or other large manufacturing company, or even in a medical malpractice claim, expenses can total a quarter to a half a million dollars or more. Thus, what some consider a charade of the "loan system" has become increasingly important. These "loans" create economic risk for plaintiffs' lawyers and can act as a deterrent against bringing marginal cases.

If Senator Specter's proposed modification of the Internal Revenue Code succeeds, the federal government will, for all intents and purposes, share in the cost and risk of bringing the initial litigation. Under current and certainly potential future tax laws, this could be as much as 40% of the cost of bringing litigation.

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How Plaintiff's Lawyers Weigh Whether to Bring a Case. Those who practice plaintiffs' lawyer work learn quickly that it is a business similar to other capital businesses. Capital is placed at risk and a judgment is made whether or not it will bring a profit. Today the costs of litigation act as a curb against marginal and frivolous litigation. This is what makes the plaintiffs' lawyers' tax proposal of such great practical importance. While one cannot calculate it mathematically, having the federal government bear 40% of the initial costs allows plaintiff's attorneys to take more cases with higher risks. The result to industries targeted by plaintiffs' lawyers will be staggering.

Senator Specter justifies his proposal by saying that the modification would "treat these businesses the same as other small businesses." A principal difference between a plaintiffs' lawyers' fronting of costs and a business' deductible expenditures is that the former carries a formal contractual obligation for future payment (much like any other type of loan agreement). Deductible business expenses are a separate animal in that they represent sunk capital costs that are not based on the vagaries of litigation.

The activity of the contingency fee lawyer is also not like other businesses. It is a business that threatens other businesses with major lawsuits and is directed at using every possible weapon to settle those lawsuits. Under the present legal system, additional weaponry in the plaintiffs' bar is not needed. To the contrary, additional weaponry is needed to stop marginal litigation and frivolous claims. Some of that marginal litigation is highly likely to be directed at financial institutions, potentially reducing those companies' capital at the very time the federal government's policy is to increase it.

Importance of this Legislation to Organized Plaintiffs' Bar. A careful reading of the American Association for Justice's (AAJ) (formerly the Association of Trial Lawyers of America) First Quarter 2009 Lobbying Report shows how important this legislation is to their powerful organization. Virtually the entire AAJ lobbying team is directed at helping assure the passage of the proposal.

In the 110th Congress, the Joint Tax Committee scored the federal bailout for trial lawyers at $1.57 billion over 10 years. We do not believe the American taxpayer will want to bear this cost. At that time, *The Wall Street Journal* editorialized that the tax change "would allow plaintiffs lawyers to deduct the up-front expenses of pursuing contingency-fee lawsuits, even in cases where the lawyer is expecting to be reimbursed for these expenses. . . Allowing these big deductions now would mean that future reimbursements are taxed, but with some monster class-actions, the lawyers could avoid the tax bill for a decade or more. Naturally, this would be an incentive to file more class-action suits, because the lawyers could write off their up-front expenditures to pursue them." Editorial, *The Bill Lerach Tax Cut*, WALL ST. J., May 30, 2008, at A14.

Although the proposal had bipartisan support in the House of Representatives last year, the spotlight of publicity killed it. Now, it is being renewed with more vigor and has more monetary and political support behind it. While the strength of political support for the bill has incremented, the need for it has been reduced. In our current economic situation, proposals that would encourage litigation are exactly contrary to the stimulus that is needed to advance our recovery. As the merits of the proposal become known, hopefully more people will be asking: do we really need a federal bailout for trial lawyers?

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