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Don't Settle for Less: Tips for Negotiating Settlement Agreements

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December 8, 2015

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Presenter: Chi Chi Wu

- Chi Chi Wu has been a staff attorney at NCLC for over a decade. Chi Chi focuses on consumer credit issues at NCLC, including legislative, administrative, and other advocacy. Chi Chi's specialties include fair credit reporting, credit cards, refund anticipation loans, and medical debt.
- Before joining NCLC, Chi Chi worked in the Consumer Protection Division at the Massachusetts Attorney General's office and the Asian Outreach Unit of Greater Boston Legal Services.
- Chi Chi is a graduate of Harvard Law School and The Johns Hopkins University.
- Chi Chi is co-author of the legal manuals Fair Credit Reporting Act and Collection Actions, and a contributing author to Consumer Credit Regulation and Truth in Lending.





Presenter: Chantal Hernandez

- Chantal Hernandez is a staff attorney at the National Consumer Law Center whose focus includes mortgage servicing and foreclosures.
- Previously, she was a staff attorney in the Foreclosure Prevention Project of MFY Legal Services in New York. At MFY, she defended homeowners sued in foreclosure through state trial and appellate litigation, representation at court-supervised settlement conferences, preparation of pro se pleadings, and negotiation of loan modifications.
- During law school, she was an intern for the Federal Trade Commission and U.S. Department of Justice and also represented clients at the Janet R. Spragens Federal Tax Clinic in Washington, D.C. She also served as a member of the American University Law Review.
- Chantal is a member of the New York Bar. She graduated cum laude from Boston University and American University, Washington College of Law.





Moderator: Tara Twomey

- Tara Twomey is currently Of Counsel to the National Consumer Law Center and the Project Director for the National Consumer Bankruptcy Rights Center. She has previously lectured in Law at Stanford, Harvard and Boston College Law Schools.
- Tara is a former Clinical Instructor at the Hale and Dorr Legal Services Center of Harvard Law School where her practice focused, in part, on sustainable homeownership for low- and moderate-income homeowners.
- She is a contributing author of several books published by the National Consumer Law Center, including Foreclosures and Bankruptcy Basics.





Don't Settle For Less: Tips for Negotiating Settlement Agreements



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Overview

- Credit Repair
- Tax Consequences
- Confidentiality

Credit Reporting Considerations for Settlements

- Make it a standard practice to negotiate credit reporting
 - If not addressed, will remain on credit record for 7 years even if paid
 - Establish precedent for your office and legal community
- Creditor may be reluctant
 - Issues about integrity of consumer reporting system
 - Instructed by credit reporting agencies not to delete information
- But
 - Information reported by creditor is NOT accurate
 - Costs the creditor nothing to revise or withdraw
 - The FCRA is a consumer protection statute

Two General Approaches

- Delete bad information (“hard delete,” delete the tradeline)
 - Creditor must contact CRA and request entire report be withdrawn.
 - Simplest, often safest
 - But could leave credit record sparse
 - Can report deletion on a “Universal Data Form”
- Replace bad information with good information
 - Report debt and payments made “as agreed”
 - Helpful if sparse credit
 - Could raise questions if entire report is reviewed
- Read § 12.6.4 of NCLC Fair Credit Reporting Act manual and Appendix J.2

Deleting Negative Information

- Agreement should prohibit re-reporting the debt
- Prohibit transfer or sale of debt
- If information is “re-inserted” or otherwise not deleted
 - Make sure consumer monitors his/her report in the future
 - Consumer should dispute debt
 - Creditor should agree that it will not verify debt

Reporting Favorable Information

- Specify exactly what reporting will be to CRAs
- Example
 - Account Status as Paid and Closed or Code 13
 - Payment Rating - 0, reflecting a current account
 - Payment History: no Past Due payment history
 - No Date of First Delinquency
 - Current Balance should be \$0.
- Review UDF
- Specify what can and cannot be said in response to oral inquiries from potential creditors

Enforcing the Agreement

- Put details in agreement
 - When transmission made
 - What transmission says
 - Copy of transmission provided to you
 - No re-reporting of the debt
 - No re-verifying of the debt
- Sample language in Appendix J.2 of FCRA manual
- Can sue creditor on contract claim
- Can dispute debt with CRA



Tax Consequences

- If borrower receives money damages or cancellation of debt, then borrower may face liability.
- Advocates should document the nature of the damages and plan for the payment of taxes and related expenses in finalizing settlement agreements.

Read NCLC Foreclosures and Mortgage Servicing
§§ 10.8, 10.9.4, 12.6 and Fair Debt Collection
§1.5.13

What is Gross Income?

- Gross income is broadly construed as income in any form (money, property, or services), from any source, unless specifically excluded by law. 26 U.S.C. § 61(a); 26 C.F.R. § 1.61-1.
- Exclusions from Gross Income, 26 U.S.C. §§ 101-140
 - §104(a)(2)- The exclusion provision applicable to lawsuits, settlements, and awards.
 - §108 - The exclusion provision applicable to cancellations of indebtedness.

Recoveries: Items of Gross Income

- Judgment interest, always. § 61(a)(2)
- Punitive damages, always. Except § 104(c)
- Cancelled debt, generally. § 61(a)(12), but § 108
- Damages for common law torts (invasion of privacy, IIED, defamation), always
- Statutory damages, always
- Liquidated damages, always
- Emotional distress damages, generally
- Contract damages, generally
- Confidentiality clauses (T.C. Memo. 2003-329)

Exclusions from Gross Income

- In determining whether the subject damages must be included in a client's gross income, you must consider the item that the damages replace
- Cash is generally taxable income
 - Unless on account of physical personal injury or physical sickness, § 104(a)(2)
 - In general, emotional distress is not treated as a physical injury or physical sickness
 - But pain and suffering damages for *physical* injury are non-taxable
 - Unless refund of money spent or capital

Cancellation of Debt

- Debt is frequently forgiven in connection with short sales, deeds in lieu, and other pre-foreclosure workout options or post-foreclosure agreements to forego collection.
- Debt may also be forgiven by statute
- The amount of the debt that is canceled, forgiven or discharged is considered cancellation of debt income (COD income).
 - Under the general rule a taxpayer's gross income includes COD income. § 61(a)(12)

Excluding COD from Gross Income § 108

- Bankruptcy - (a)(1)(A)
- Insolvency – (a)(1)(B)
- Qualified farm indebtedness (a)(1)(C)
- Qualified real property business indebtedness (a)(1)(D)
- Qualified principal residence – (a)(1)(E)
 - Discharged before January 1, 2015

Order of §108(a) Exclusions

- Bankruptcy exclusion
- Insolvency exclusion
- If not elected otherwise, qualified principal residence exclusion takes precedence over insolvency exclusion.

IRC 108(a)(2)

Bankruptcy Exclusion

- If the COD occurs in the context of a bankruptcy, the entire amount of COD qualifies for exclusion from gross income.
- The timing of the bankruptcy filing is crucial.
 - To qualify for the bankruptcy exclusion, the taxpayer must be under the jurisdiction of a bankruptcy court at the time of the discharge and the discharge must be granted by the court or pursuant to a plan approved by the court.
 - If a debt forgiveness agreement is reached before the filing of the bankruptcy and the insolvency exclusion does not apply, the “taxable event” has occurred and the tax is due.

Insolvency Exclusion

- COD income is excludable from gross income if the taxpayer is insolvent prior to receiving the discharge, to the extent of the insolvency. § 108(a)(3)
 - Insolvency is defined as an excess of liabilities over the fair market value of assets, as determined immediately prior to the discharge.
 - COD income greater than the insolvency is *not* excludable
- **Example 1**
 - Taxpayer with assets valued at \$18,000 and liabilities of \$26,000.
 - Insolvent by \$8,000
 - If \$6000 of the debt is discharged, the debtor has \$6000 worth of COD income. The entire amount of the COD income would be excludable because the amount of the COD income was less than the amount of the initial insolvency.
- **Example 2**
 - Taxpayer with assets valued at \$18,000 and liabilities of \$26,000
 - Insolvent by \$8,000
 - If \$11,000 of the debt is discharged, only \$8000 of the COD income (the amount by which the debtor was initially insolvent) would be excludable. The debtor would have to include \$3000 of the COD income (the amount by which the discharge of debt made the debtor solvent) in gross income.

1099-C: When COD Income Must Be Reported

- An applicable entity must issue a 1099-C reporting discharge of indebtedness if and only if one of eight “identifiable events” has occurred ... whether or not an actual discharge of indebtedness has occurred.
Treas. Reg. 1.6050P-1
 - 1099-C is a reporting mechanism and does not necessarily reflect a taxable event
 - “Applicable financial entity” includes debt buyers. 26 CFR 6050P-2(e)

Triggering Events: When COD Must Be Reported

- Under the IRS regulations, there are eight triggering events that result in a creditor's reporting of COD income for individuals. 26 C.F.R. § 1.6050P-1(b)
 - Bankruptcy discharge;
 - Cancellation/extinguishment rendering a debt unenforceable in a receivership, foreclosure, or similar court proceeding;
 - Expiration of the statute of limitations, including the passing of any appeals period;
 - A statutory bar on further collection upon the creditor's election of remedies;
 - Cancellation of debt in probate;
 - An agreement between the creditor and the borrower;
 - Discharge by decision or defined policy of creditor to discontinue collection;
 - 36-month non-payment testing period.

When COD Need Not Be Reported

- Discharged debt less than \$600 need not be reported.
- Discharged interest and fees also need not be reported, although they may be reported.
- Purchase Price Reduction is not COD and does not need to be reported
- There is no penalty imposed on creditors for failing to report discharged disputed debt.
- Creditors should not report debt that was never due and owing.

Purchase Price Reduction

§ 108(e)(5)

- Retroactive purchase price reduction does not result in COD income if property is bought at an inflated price on credit.
- Courts have tended to interpret 108(e)(5) narrowly:
 - No PPR where the only relationship between the parties is that of debtor and creditor & there was no sale of property. Payne v Comm'r, T.C.M. 2008-66 (2008) (aff'd 8th Cir.)
 - No PPR where the financing bank was not also the seller of the property. Preslar v. Comm'r, 167 F3d 1323 (10th Cir. 1999), Bross v. Comm'r. T.C. Summ. Op. 2012-122

Purchase Price Reduction (Continued)

- Exception to the exception: IRS will treat debt reductions by remote lenders as price reductions in cases where an “infirmity” clearly relates back to the original sale. Rev. Rul. 92-99; Preslar
- Incorporate into settlement agreement:
 - “Tax Treatment of Discharge. The parties agree the settlement of this matter constitutes an adjustment of the purchase price of the vehicle. Accordingly, the defendant will not file a Form 1099-C with the Internal Revenue Service reporting any discharge of indebtedness.”

Disputed Debt

- A taxpayer who in good faith disputes the original amount of a debt and settles it for a lesser amount, can use the settlement amount when computing COD income.
Preslar v. Comm'r, 167 F3d 1323 (10th Cir. 1999)
 - This is the generally accepted statement of the doctrine everywhere except the 3rd Circuit

Disputed Debt (Continued)

- Taxpayer must provide evidence of bona fide dispute to invoke the contested liability doctrine. Rood v. Comm'r., T.C. Memo. 1996-248, aff'd per curiam, 122 F.3d 1078 (11th Cir. 1997).
- Settlement alone is not evidence of a good faith dispute. McCormick v. Comm'r., T.C. Memo 2009-239.
- Taxpayer must have raised his bona fide dispute as a defense to the debt collection action.
- Taxpayer shouldn't file returns that are inconsistent with position that the debt is disputed. Marcaccio v. Comm'r., T.C. Memo 1995-174

Example: Disputed Debt and No 1099-C

Reporting of Disputed Legal Claims:

It is understood and agreed by the Parties that this Agreement reflects settlement of disputed legal claims, including the liquidated value of the debt, and does not involve a discharge or cancellation of any debt. Lender therefore agrees that it will not report the settlement of the disputed legal claims as resulting in any income to the Borrowers, to any tax authority, and Lender, accordingly, will not issue an IRS 1099-C notice with respect to the Payment or any other consideration in connection with this Agreement.

Attorney's Fees

- The full amount of contingent attorney's fees as part of a court award or settlement are included in an individual's gross income. C.I.R. v. Banks, 543 U.S. 426 (2005)
 - Banks did not rule on the tax treatment of attorney's fees paid by court order under fee-shifting statutes.
 - But since, the Tax Court has held that even if a court orders the payment of attorney's fees under a fee-shifting statute, the fees are still income to the plaintiff. Vincent v. Comm'r., T.C. Memo 2005-95
- But fees are non-taxable if:
 - You obtain a non-taxable recovery for your client then your fees will be non-taxable.
 - The client has no obligation, contractual or otherwise, to pay legal fees or other costs. IRS Private Letter Ruling 201015016.
 - Ex) Legal services retainers
 - NACA seeking IRS PLR on model retainer re: attorney's fees language
 - Opt-out class actions, generally.

Specify the Source of Damages

- When a settlement involves both taxable and non-taxable damages, the documents should specify the percentage of the settlement related to each source of damages.
- IRS will initially rely on this allocation, but it is not conclusive.

Settlement Strategies to Minimize Tax Consequences

- Document potential exclusions from taxable income
- Specify in settlement agreement that there is no COD income
- Specify in settlement agreement that the debt is disputed or settles disputed claims
- Specify in settlement agreement that your client is not liable for the debt/does not owe a debt to the putative creditor
- If reporting required, explain that the creditor does not have to report anything beyond the stated principal amount
- Specify in the settlement agreement that creditor will not file a 1099-C if it not required to do so
- Ensure that the client, where appropriate, has competent independent tax advice
- Set money aside from the settlement to cover payment of taxes and tax advisor's fees when necessary

Confidentiality

- Confidentiality clauses can prohibit borrowers, and at times attorneys, from disclosing the terms of a settlement to anyone or publicizing a settlement.
- Such agreements leave the litigation unsettled because they invite the lender/servicer to sue the borrower years later, alleging disclosure of the settlement.
- Discuss confidentiality **before** you begin settlement negotiations

Ethical Concerns

- Rule 1.2(a)

A lawyer shall abide by a client's decision whether to accept an offer of settlement of a matter.

- Rule 1.4(b)

A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.

Ethical Concerns

- Rule 3.4

A lawyer shall not (f) request a person other than a client to refrain from voluntarily giving relevant information to another party unless:
(2) the lawyer reasonably believes that the person's interest will not be adversely affected by refraining from giving such information.

- Rule 5.6

A lawyer shall not participate in offering or making: (b) an agreement in which a restriction on the lawyer's right to practice is part of the settlement of a controversy.

Responding to Opponents Request for Secrecy

- Client policy is to have confidential agreements
- Not a matter of public interest or public safety
- Settlement amount will be used to encourage copycat lawsuits
- Settlement will not be signed without confidentiality agreement

Why Oppose Confidentiality?

- Undermines justice system
- Threatens public health and safety and/or public interest
- Hamstrings future advocacy
- Puts clients at risk
- Potential tax consequences
- May be unethical

Alternative to Confidentiality

- Remove provisions and instead issue joint press release
 - Addresses concerns of slander and bad publicity
 - Allows creditor to help shape any initial presentation of the facts to the outside world and to ensure that the press has a designated contact person to call to give the creditor's version of events

If You Must Agree, Put A Price On It

- Take into account potential tax consequences
 - Any portion of the settlement amount attributable to confidentiality clause is taxable income
 - If tax liability will be substantial, consider asking for additional money to cover the taxes and/or fees of a tax professional
- Document in agreement or correspondence with the creditor how much was paid for the confidentiality clause

If You Must Agree, Limit Provisions

- Amount of settlement only
 - Not as to facts
 - Not as to documents in the public record
- Not as to funders
- Not as to tax advisors
- Not as to disputes with CRA
- Not as to attorney's right to practice law
- No binding effect on client

Questions?

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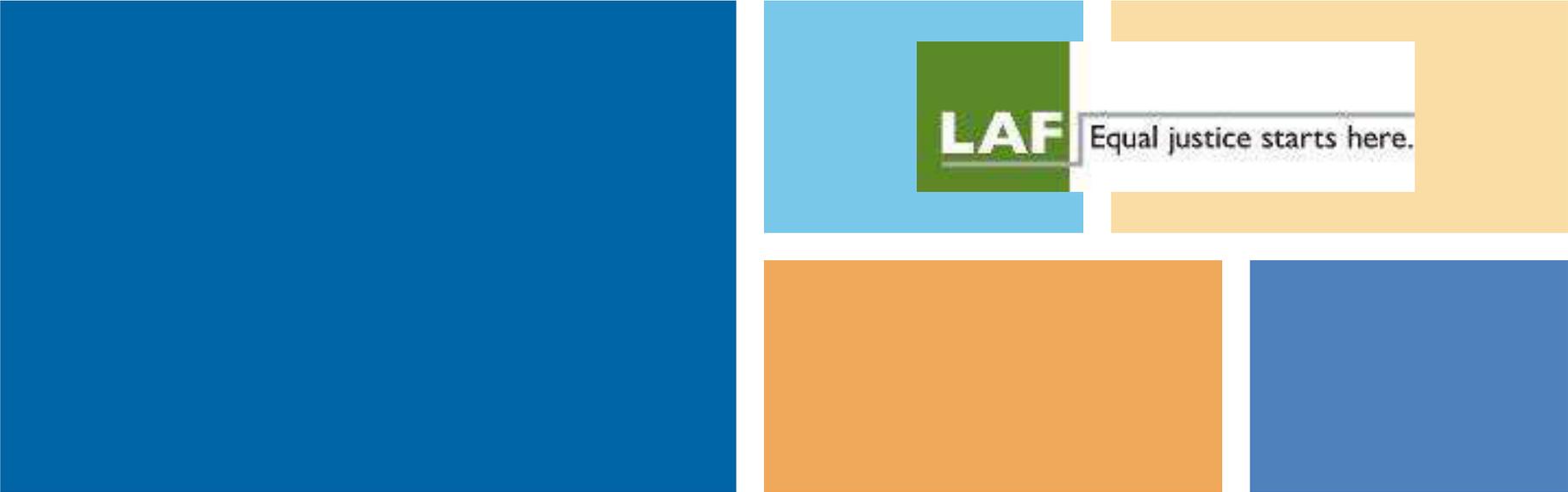
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