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DOCUMENT NO.	FORM	SUBJECT/TITLE	PAGES	DATE	RESTRICTION(S)
001	Outline	The Intermediate Sanctions Compensatory Revenue Adjustment Act… [2 PAGES RELEASED IN WHOLE ON PRA RE-REVIEW 09/15/2025 JLS]	2	N.D.	
002	Outline	The Intermediate Sanctions Compensatory Revenue Adjustment Act… [2 PAGES RELEASED IN WHOLE ON PRA RE-REVIEW 09/15/2025 JLS]	2	N.D.	
003	Outline	The Intermediate Sanctions Compensatory Revenue Adjustment Act… [2 PAGES RELEASED IN WHOLE ON PRA RE-REVIEW 09/15/2025 JLS]	2	N.D.	
004	Outline	The Intermediate Sanctions Compensatory Revenue Adjustment Act… [2 PAGES RELEASED IN WHOLE ON PRA RE-REVIEW 09/15/2025 JLS]	2	N.D.	

COLLECTION TITLE:
Counsel's Office, White House

SERIES:
Kavanaugh, Brett - Subject Files

FOLDER TITLE:
ISCRAA (Intermediate Sanctions Compensatory Revenue Adjustment Act) Fees

FRC ID:
9702

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
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PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).

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DOCUMENT NO.	FORM	SUBJECT/TITLE	PAGES	DATE	RESTRICTION(S)
005	Outline	The Intermediate Sanctions Compensatory Revenue Adjustment Act… [2 PAGES RELEASED IN WHOLE ON PRA RE-REVIEW 09/15/2025 JLS]	2	N.D.	
006	Outline	The Intermediate Sanctions Compensatory Revenue Adjustment Act… [2 PAGES RELEASED IN WHOLE ON PRA RE-REVIEW 09/15/2025 JLS]	2	N.D.	
007	Note	Materials for Friday Meeting… - To: Brett Kavanaugh - From: Domestic Policy Council	1	04/22	b6;
008	Report	ISCRAA Issues… [4 PAGES RELEASED IN WHOLE ON PRA RE-REVIEW 09/15/2025 JLS]	4	04/23/2003	

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009	Memorandum	ISCRAA and Congress's Power to Tax [3 PAGES RELEASED IN WHOLE ON PRA RE-REVIEW 09/15/2025 JLS] - To: Brett Kavanaugh - From: Joe Matal	3	04/31/2003	

COLLECTION TITLE:
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SERIES:
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SUPERSEDED

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001	Outline	The Intermediate Sanctions Compensatory Revenue Adjustment Act…	2	N.D.	P5;
002	Outline	The Intermediate Sanctions Compensatory Revenue Adjustment Act…	2	N.D.	P5;
003	Outline	The Intermediate Sanctions Compensatory Revenue Adjustment Act…	2	N.D.	P5;
004	Outline	The Intermediate Sanctions Compensatory Revenue Adjustment Act…	2	N.D.	P5;
005	Outline	The Intermediate Sanctions Compensatory Revenue Adjustment Act…	2	N.D.	P5;
006	Outline	The Intermediate Sanctions Compensatory Revenue Adjustment Act…	2	N.D.	P5;

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This document was prepared on Tuesday, October 23, 2018

The Intermediate Sanctions Compensatory Revenue Adjustment Act (ISCRAA)
S. 887 (Kyl-Cornryn)

I. Scope

- Sets "reasonable" hourly rates for attorneys where judgment exceeds $100M
- Imposes excise tax of 200% on excess of 500 time reasonable fee
- Lawyers may avoid excise tax by giving excess fee back to client
- However, lawyers must still pay 5% tax on excess fee (could drop most of this provision)
- May not disavow entitlement to fee

II. Impact

- Transfer of $8B (which is present value) from attorneys to States (arbitrated fees are to be paid out of fund capitalized at $500M/year)
- Avoid securitization of income streams right now

III. Legal considerations

- Power to Tax

-- Power to tax income generated in the U.S. is not limited by Federalism principles.

-- Applies to suits with judgments in excess of $100 million, which is standard for commerce clause involvement even when not dealing with taxes.

- Retroactivity

-- Provision taxes amounts taken into income in current and future years, but if excessive fees were received prior to June 2002, no tax would be imposed.

-- Only applies pre-existing fiduciary standards.

IV. Policy considerations

- Why should Congress reopen fee agreement negotiated by States

--This does not actually change the contracts negotiated between the states and the lawyers. It simply sets a practical ceiling for the fees that can be awarded by the arbitrators.

--Although each state regulates the legal profession and limits recovery of fees to reasonable rates, state courts have been reluctant to enforce the

provision absent complaints from client. In many instances, however, the state AG colluded in agreeing to the unreasonable fees. They also argue that the arbitration awards are not fees because they are paid directly to the attorney by the companies.
-- MSA provides that if any state changes the fee structure, they lose one-third of the full recovery.

Kyl-Cornyn does not regulated fee awards, it merely taxes fee awards at a higher rate.

- Is there precedent is there for imposing excise taxes on fees

-- The precedent for this tax is the IRS provision that requires employees, foundations execs, and pension fund trustees to refund unreasonable salary and benefit payments or pay a 200 percent tax. This provision would simply extend that to lawyers, who also have fiduciary duties to clients.
--The Committee Report when Section 4958 of the Code was adopted said that: "The fact that a state or local legislative body may have authorized a particular compensation package is not determinative of the reasonableness of compensation paid for purposes of the excise tax penalties provided for by the proposal."

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THE WHITE HOUSE

WASHINGTON

Date: 4/22

To: Brett Kavanaugh

From: **Domestic Policy Council**

Margaret Pederlin

____ FYI

____ Appropriate Action

____ Direct Response

____ Prepare Response For My Signature

____ Per Our Conversation

Thomas's staff

✓ Let's Discuss

____ Per Your Request

____ Please Return

____ Deadline

____ Other Joe Matal 301-938-[redacted]779 (h) (b)(6)

Comments: (b)(6)

Materials for Friday meeting on Tort Reform

3:45

HUDSON INSTITUTE

PROJECT FOR CIVIL JUSTICE REFORM

Michael J. Horowitz
Director

Congress'tory

ATLA

MEMORANDUM
VIA FAX AND EMAIL

should it be 200% of excess fee or [25%] of total fee → coercive → House-ripe to put in mark

TO: **Jay Lefkowitz**
Cesar Conda
Brett Kavanaugh
FROM: Michael Horowitz
DATE: April 23, 2003
RE: **"Wage Regulation" arguments against Kyl-Cornyn**

In addition to material previously sent, I'm attaching the memo prepared today by Joe Matal re the so-called "wage regulation" argument that might be used against Kyl-Cornyn. (Pages 8-10 of the Kyl floor statement address the same issue in further detail; the attachment to the e-mail version of this memo includes that excerpt.)

To give context to the Matal memo, and to make absolutely clear that Kyl-Cornyn is not a fee cap bill, consider the following hourly claims that have been made by the tobacco lawyers, and the fees they would be eligible to receive under the bill on the reasonable assumption of a court-authorized $400 per hour fee and 5x multiplier:

- *Castano* group lawyers: 400,000 hours - $800 million
- NY lawyers: 48,000 hours - $96 million
- Texas lawyers: 36,000 hours - $72 million
- Illinois and Ohio lawyers: 15,000-20,000 hours - $30 million
- Michigan lawyers: 20,000 hours - $40 million
- Wisconsin lawyers: 26,500 hours - $53 million
- California lawyers: 128,000 hours - $256 million

As can be seen, fees authorized under Kyl-Cornyn, even divided among lawyers and across the years of litigation, are well within current CEO compensation.

1015 18th Street, N.W., Suite 300, Washington, DC 20036
202-223-9200 Fax: 202-223-8537

But entirely aside from the size of legitimate fees under Kyl-Cornyn, please examine Joe Matal's superb memo, compelling in making clear that the bill merely creates a means of enforcing ***existing law*** – one that, in recognition of the fiduciary character of the attorney-client relationship, currently requires judicial regulation/supervision/ review of all attorneys' fees in all states.

court would find cong does not have authority * state court * retroactivity

ISCRAA ISSUES: FREEDOM OF CONTRACT/WAGE REGULATION

Question: **Doesn't ISCRAA set a precedent for having the I.R.S. regulate professionals' salaries and incomes? Doesn't this violate freedom of contract?**

Short answer: **ISCRAA requires courts, not the I.R.S., to continue doing what they already do: to review attorneys fees for reasonableness. The courts have made very clear that attorneys fee agreements are not analogous to ordinary business contracts – attorneys are fiduciaries, who already are required to charge only reasonable fees by the ethics rules of all 50 States. ISCRAA does not change these substantive requirements; it merely makes them enforceable in an area where there has been gross abuse – the mass tort case.**

1. Courts, not the I.R.S., apply the ISCRAA fee formula.

Unlike earlier versions of proposals similar to ISCRAA, the Kyl-Cornyn bill would require *courts*, not the I.R.S., to apply a fee formula in mass-tort cases. S. 887 requires the court to hire a legal auditing firm to review the attorney's billing records in order to determine a baseline lodestar fee. (*See* ISCRAA at pp.12-14, §4959(h).) The court then applies ISCRAA's muliplier formula to this lodestar. (*See* ISCRAA at pp.3-7, §4959(c).) ISCRAA's fee formula is merely a codification of a liberal interpretation of the courts' own practices when awarding reasonable fees in mass-tort cases. And so long as the court obtains and relies on the report of the legal auditing firm, and applies the ISCRAA fee formula, that fee is *presumed correct* for I.R.S. purposes. (*See* ISCRAA at p.7, §4959(c)(1)(D).) I.R.S. enforcement is merely a fail-safe mechanism under ISCRAA, designed to ensure that *the court* sets the fee in accordance with the fee formula. It is *the court* that has discretion to set the lodestar (the baseline reasonable hours) and to apply an appropriate multiplier; so long as the court does so, the I.R.S. plays no substantive role under ISCRAA.

not even required to be lower fed courts

commandeering

IRS

take out instruction to state courts

operates cleanly → IRS

Printz → courts are different

FERC v. Mississippi → distinguishing adjudicative

2. Because lawyers are fiduciaries, courts have *explicitly rejected* analogies between attorneys fee agreements and other business contracts.

Attorneys long have been acknowledged to be fiduciaries who occupy a position of trust in their dealings with their clients. One obligation that flows from this status, universally recognized in the ethics rules of all 50 States, is the attorney's obligation not to charge an unreasonable or excessive fee. Courts have made very clear that attorneys are not equivalent to ordinary businessmen, who can engage in hard bargaining with their customers. Such behavior cannot be reconciled with an attorney's role as an officer of the court. The courts also have made clear that the requirement that a fee be reasonable will be read into every attorney fee contract, and will supercede terms that are inconsistent with this obligation. (*See also* Senator Kyl's speech introducing ISCRAA, attached.)

According to the courts:

- "We realize that business contracts may be enforced between those in equal bargaining capacities, even though they turn out to be unfair, inequitable or harsh. However, *a fee agreement between lawyer and client is not an ordinary business contract.* The

(1) std of conduct not retroactive – are
(2) 12-month retroactive tax is not problem → prob pass

profession has both an obligation of public service and duties to clients which transcend ordinary business relationships and prohibit the lawyer from taking advantage of the client."[1]

- "*There is but little analogy between the elements that control the determination of a lawyer's fee and those which determine the compensation of skilled craftsmen in other fields. Lawyers are officers of the court.* The court is an instrument of society for the administration of justice. Justice should be administered economically, efficiently, and expeditiously. The attorney's fee is, therefore, a very important factor in the administration of justice, and if it is not determined with proper relation to that fact it results in a species of social malpractice that undermines the confidence of the public in the bench and bar. It does more than that. It brings the court into disrepute and destroys its power to perform adequately the function of its creation."[2]

- "[A]n attorney is only entitled to fees which are fair and just and which adequately compensate him for his services. This is true *no matter what fee is specified in the contract*, because an attorney, as a fiduciary, cannot bind his client to pay a greater compensation for his services than the attorney would have the right to demand if no contract had been made. Therefore, as a matter of public policy, *reasonableness is an implied term in every contract for attorney's fees.*"[3]

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[1] *In the Matter of Swartz*, 686 P.2d 1236, 1243 (Ariz. 1984) (emphasis added). *See also Vaughn v. King*, 975 F.Supp. 1147 (N.D.Ind.1997) ("there are legal rules that limit the ability of a lawyer and her client to contract freely. Under Indiana law, an attorney is entitled only to reasonable fees regardless of the existence of a contract between her and her client.") (citing *Trinkle v. Leeney*, 650 N.E.2d 749, 754 (Ind.Ct.App.1995).

[2] *Kuhnlein v. Department of Revenue*, 662 So.2d 309, 313 (Fla. 1995) (emphasis added). *See also Gruber & Coabella, P.A. v. Erickson*, 784 A.2d 758, 760 (N.J.Sup.Ct. 2001) ("Attorneys have never had the right to enforce contractual provisions for more than a fair and reasonable fee. They are not businessmen entitled to charge what the traffic will bear").

[3] *Missouri ex rel. Chase Resorts, Inc. v. Campbell*, 913 S.W.2d 832 (Mo. App. 1996) (emphasis added). *See also* G. Hazard, ETHICS IN THE PRACTICE OF LAW 99 (1978) ("A contract for a [legal] fee is, under general principles of law, a contract between a fiduciary and his protected dependent * * * [and] it is unenforceable unless its terms are fair to the client").

3. The model rules, and the ethics rules of all 50 States, *already* require attorneys to charge only reasonable fees.

ISCRAA does not change the *substantive* law governing attorneys fee awards. Rather, it simply enforces established, *pre-existing* fiduciary standards that already bind every attorney in every state. The MODEL RULES OF PROFESSIONAL CONDUCT, at Rule 1.5(a), contain a clear, direct command that "*a lawyer's fee shall be reasonable.*" Similarly, the MODEL CODE OF PROFESSIONAL RESPONSIBILITY, at DR 2-106, directs that an attorney "*shall not* enter into an agreement for, charge, or *collect an illegal or clearly excessive fee.*" The Model Code further explains that an attorney's fee is "clearly excessive when, after a review of the facts, a lawyer of ordinary prudence would be left with a definite and firm conviction that the fee is in excess of a reasonable fee." Finally, as academic commentators point out, in addition to the model rules, "*all state rules of professional conduct prohibit attorneys from charging excessive fees.*"[4] (Emphasis added.)

4. Courts *already* review attorneys fees for reasonableness.

According to the courts:

- "Courts have broad authority to refuse to enforce contingent fee arrangements that award excessive fees. A fee can be unreasonable and subject to reduction without being so 'clearly excessive' as to justify a finding of breach of ethical rules."[5]

- "[R]egardless of how a fee is characterized[,] each fee agreement must be carefully examined on its own facts for reasonableness."[6]

- "[F]ew propositions are better established than that our courts do retain power of supervision to consider, notwithstanding the agreement, a client's challenge thereto as unreasonable, unconscionable, exorbitant or for any reason that would move a court of equity to modify it or set it aside."[7]

- "Despite attorney fee contracts[,] courts may inquire as to the reasonableness of attorney fees as part of their prevailing, inherent authority to regulate the practice of law."[8]

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[4]Vonde M. Smith Hitch, *Ethics and the Reasonableness of Contingency Fees: A Survey of State and Federal Law Addressing the Reasonableness of Costs as They Relate to Contingency Fee Agreements*, 29 LAND & WATER L. REV. 215, 218 n.22 (1994).

[5]*Green v. Nevers*, 111 F.3d 1295, 1302 (6th Cir. 1997) (*citing McKenzie Const., Inc. v. Maynard*, 758 F.2d 97, 100 (3rd Cir.1985)).

[6]*In the Matter of Connelly*, 55 P.3d 756, 761 (Ariz. 2002).

[7]*Golden v. Guaranty Acceptance Capital Corp.*, 807 F.Supp. 1161, 1164 (S.D.N.Y. 1992) (citations omitted).

[8]*Souhlas v. Orlando*, 629 So.2d 513, 515 (La. App. 1993).

- "Under a court's general supervisory power over attorneys as officers of the court, attorney fee contracts are subject to scrutiny for the reasonableness of their terms."[9]

- "[A]lthough parties are permitted to contract with respect to attorney fees, attorney fees are subject to review and control by the courts. Moreover, the reasonableness of an attorney fee award is always subject to court scrutiny."[10]

- "As a matter of public policy, courts pay particular attention to fee arrangements between attorneys and their clients[,] and the reasonableness of attorney's fees is always subject to court scrutiny. An attorney has the burden of showing that a fee contract is fair, reasonable, and fully known and understood by the client."[11]

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[9] *Law Offices of J.E. Losavio, Jr. v. Law Firm of Miachel W. McDivitt, P.C.*, 865 P.2d 934, 936 (Colo. App. 1993).

[10] *Succession of Abdalla*, 764 So.2d 362, 367 (La. App. 2000).

[11] *Bizar & Martin v. U.S. Ice Cream Corp.*, 644 N.Y.S.2d 753, 754 (Sup.Ct. 1996) (citing cases).

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S 887 IS

108th CONGRESS
1st Session
S. 887

To amend the Internal Revenue Code of 1986 to apply an excise tax to excessive attorneys fees for legal judgments, settlements, or agreements that operate as a tax.

IN THE SENATE OF THE UNITED STATES

April 10, 2003

Mr. KYL (for himself and Mr. CORNYN) introduced the following bill; which was read twice and referred to the Committee on Finance

A BILL

To amend the Internal Revenue Code of 1986 to apply an excise tax to excessive attorneys fees for legal judgments, settlements, or agreements that operate as a tax.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the `Intermediate Sanctions Compensatory Revenue Adjustment Act of 2003' (ISCRAA).

SEC. 2. EXCISE TAXES ON EXCESS FEE TRANSACTIONS OF CERTAIN ATTORNEYS.

(a) IN GENERAL- Subchapter D of chapter 42 of the Internal Revenue Code of 1986 (relating to failure by certain charitable organizations to meet certain qualification requirements) is amended by adding at the end the following new section:

`SEC. 4959. TAXES ON EXCESS FEE TRANSACTIONS.

`(a) INITIAL TAXES- There is hereby imposed on the collecting attorney in each excess fee transaction a tax equal to 5 percent of the excess fee. The tax imposed by this paragraph shall be paid by any collecting attorney referred to in subsection (f)(1) with respect to such transaction.

`(b) ADDITIONAL TAX ON THE COLLECTING ATTORNEY- In any case in which a tax is imposed by subsection (a) on an excess fee transaction and the excess fee involved in such transaction is not corrected within the taxable period, there is hereby imposed a tax equal to 200 percent of the excess fee involved. The tax imposed by this paragraph shall be paid by any collecting attorney referred to in subsection (f)(1) with respect to such transaction.

`(c) EXCESS FEE TRANSACTION; EXCESS FEE- For purposes of this section--

`(1) EXCESS FEE TRANSACTION-

`(A) IN GENERAL- The term `excess fee transaction' means any transaction in which a fee is provided by an applicable plaintiff (including payments resulting from litigation on behalf of an applicable plaintiff

determined on an hourly or percentage basis, whether such fee is paid from the applicable plaintiff's recovery, pursuant to a separately negotiated agreement, or in any other manner), directly or indirectly, to or for the use of any collecting attorney with respect to such applicable plaintiff if the amount of the fee provided exceeds the value of the services received in exchange therefor or subsection (g)(1) applies.

`(B) DETERMINATION OF VALUE- For purposes of subparagraph (A), in determining whether the amount of the fee provided exceeds the value of the services received in exchange therefor, the value of the services shall be the sum of--

`(i) the reasonable expenses incurred by the collecting attorney in the course of the representation of the applicable plaintiff, and

`(ii) a reasonable fee based on--

`(I) the number of hours of non-duplicative, professional quality legal work provided by the collecting attorney of material value to the outcome of the representation of the applicable plaintiff, taking into account the factors described in subparagraphs (B) and (D) of subsection (h)(2),

`(II) reasonable hourly rates for the individuals performing such work based on hourly rates charged by other attorneys for the rendition of comparable services, including rates charged by adversary defense counsel in the representation, taking into account the factors described in subparagraphs (A), (C), (E), and (G) of subsection (h)(2), and

`(III) to the extent such items are not taken into account in establishing the reasonable hourly rates under subclause (II), an appropriate adjustment rate determined in accordance with subparagraph (C) to compensate the collecting attorney for periods of substantial risk of non-payment of fees and for skillful or innovative services which increase the amount of the applicable plaintiff's recovery.

`(C) ADJUSTMENT RATE-

`(i) IN GENERAL- For purposes of this paragraph, an appropriate adjustment rate is a percentage of the reasonable hourly rate under subparagraph (B)(ii)(II) which is added to the amount of such rate and which is not more than the sum of one risk percentage and one skill percentage described in clauses (ii) and (iii), respectively.

`(ii) RISK PERCENTAGE- For purposes of this subparagraph, the term `risk percentage' means a percentage rate that is proportional to the collecting attorney's risk of nonrecovery of fees and which is--

`(I) in the case of a collecting attorney who assumed a substantial risk of nonpayment of fees, not more than 100 percent,

`(II) in the case of a collecting attorney who assumed a substantial risk of nonpayment of fees and devoted more than 8,000 hours of legal

work (as described in subparagraph (B)(ii)(I)) and more than 2 years to the case before resolution of all claims, not more than 200 percent, or

`(III) in the case of a collecting attorney who assumed a substantial risk of nonpayment of fees and devoted more than 15,000 hours of legal work (as described in subparagraph (B)(ii)(I)) and more than 4 years to the case before resolution of all claims, not more than 300 percent.

`(iii) SKILL PERCENTAGE- For purposes of this subparagraph, the term `skill percentage' means, in the case of a collecting attorney who has demonstrated exceptionally skillful or innovative legal service which generated a recovery for the applicable plaintiff substantially greater than the typical recovery in similar cases, a percentage rate that is proportional to the increase in the applicable plaintiff's recovery and that is not more than 100 percent.

`(iv) LIMITATION- An appropriate adjustment rate shall not increase the collecting attorney's fee above an amount that is proportional to the applicable plaintiff's recovery.

`(D) COURT APPROVAL OF FEES- Fee payments approved by any court shall be presumed to not be in excess of the value of the services received in exchange therefor if the court approving the fee--

`(i) did not approve an adjustment rate greater than that determined to be appropriate under subparagraph (C) in a case where such fee included an adjustment rate, and

`(ii) obtained and relied upon a report of a legal auditing firm with respect to such fee in accordance with the procedures in subsection (h).

`(2) EXCESS FEE- The term `excess fee' means the excess referred to in paragraph (1)(A).

`(d) JOINT AND SEVERAL LIABILITY- For purposes of this section, if more than 1 person is liable for any tax imposed by subsection (a), all such persons shall be jointly and severally liable for such tax.

`(e) APPLICABLE PLAINTIFF- For purposes of this section, the term `applicable plaintiff' means any person represented by a collecting attorney with respect to a claim described in subsection (f)(1).

`(f) OTHER DEFINITIONS AND RULES- For purposes of this section--

`(1) COLLECTING ATTORNEY- The term `collecting attorney' means any person engaged in the practice of law who represents--

`(A) any governmental entity, including any State, municipality, or political subdivision of a State, or any person acting on such entity's behalf, including pursuant to Federal or State Qui Tam statutes, in a claim for recoupment of payments made or to be made by such entity to or on

behalf of any natural person by reason, directly or indirectly, of a breach of duty that causes damage to such natural person,

`(B) any organization described in paragraph (3) or (4) of section 501(c) and exempt from tax under section 501(a), in a claim for damages based on a breach of duty, whether civil or criminal, causing damage to such organization,

`(C) any natural person seeking to recover damages in a claim based on breaches of duty, whether civil or criminal, causing damage to such natural person, or

`(D) any assignee or other holder of claims described in subparagraph (A), (B), or (C),

when 1 or more of such claims, whether or not joined in 1 action, involve the same or a coordinated group of plaintiff's attorneys or similarly situated defendants, arise out of the same transaction or set of facts or involve substantially similar liability issues, and result in settlements or judgments aggregating at least $100,000,000.

`(2) TAXABLE PERIOD- The term `taxable period' means, with respect to any excess fee transaction, the period beginning with the date on which the transaction occurs and ending 90 days after the earliest of--

`(A) the date of the mailing of a notice of deficiency under section 6212 with respect to the tax imposed by subsection (a), or

`(B) the date on which the tax imposed by subsection (a) is assessed.

`(3) CORRECTION-

`(A) GENERAL RULE- Any excess fee transaction is corrected by undoing the excess fee to the extent possible and taking any additional measures necessary to place the applicable plaintiff in a financial position not worse than that in which such plaintiff would be if the collecting attorney were dealing under the highest fiduciary standards.

`(B) PAYMENT OF EXCESS FEES-

`(i) IN GENERAL- Except as provided in clause (ii), a collecting attorney corrects an excess fee transaction by paying any excess fees plus interest to the applicable plaintiff.

`(ii) CERTAIN SETTLEMENTS- In the case of excess fees arising from or related to that certain Master Settlement Agreement of November 23, 1998, and other, concluded Settlement Agreements based on State health care expenditures pursuant to title XIX of the Social Security Act (42 U.S.C. 1396 et seq.), including lawsuits involving the States of Florida, Minnesota, Mississippi, and Texas, the collecting attorney corrects an excess fee transaction by paying any excess fees plus interest to the 50 States in proportion to each State's share of the United States population.

`(C) NO WAIVER OF FEE- No collecting attorney may avoid imposition of any tax imposed by this section by transferring any portion of the excess fee or refusing to accept any portion of the excess fee.

`(g) DISCLOSURE REQUIREMENTS-

`(1) TREATMENT AS EXCESS FEE- Any fee provided after the date of the enactment of this subsection by an applicable plaintiff (including payments resulting from litigation on behalf of an applicable plaintiff determined on an hourly or percentage basis, whether such fee is paid from the applicable plaintiff's recovery, pursuant to a separately negotiated agreement, or in any other manner), directly or indirectly, to or for the use of any collecting attorney with respect to such applicable plaintiff shall be deemed to be an excess fee provided in an excess fee transaction unless the disclosure requirements described in paragraph (2) are met.

`(2) CONTENTS OF STATEMENT- The disclosure requirements of this paragraph are met for any taxable year in which a collecting attorney receives any fees with respect to a claim described in subsection (f)(1), if such collecting attorney--

`(A) includes in the return of tax for such taxable year a statement including the information described in subsection (c)(1) with respect to such claim, and

`(B) provides a statement including the information described in subsection (c)(1) to the applicable plaintiff prior to the deadline (including extensions) for filing such return.

`(h) LEGAL AUDITING FIRM-

`(1) IN GENERAL- In any case before a Federal district court or a State court in which the court approves fees paid to a collecting attorney, the court shall seek bids from legal auditing firms with a specialty in reviewing attorney billings and select 1 such legal auditing firm to review the billing records submitted by the collecting attorney, under the same standards the firm would use if it were hired by a private party to review legal bills submitted to the party, for the reasonableness of such attorney's billing patterns and practices. The court shall require the collecting attorney to submit billing records, cost records, and any other information sought by such firm in its review.

`(2) REVIEW BY LEGAL AUDITING FIRM- In reviewing the billing records and work performed by the collecting attorney, the legal auditing firm shall address all relevant matters, including--

`(A) the hourly rates of the collecting attorney compared with the prevailing market rates for the services rendered by the collecting attorney,

`(B) the number of hours worked by the collecting attorney on the case compared with other cases that the collecting attorney worked on during the same period,

`(C) whether the collecting attorney performed tasks that could have been performed by attorneys with lower billing rates,

`(D) whether the collecting attorney used appropriate billing methodology, including keeping contemporaneous time records and using appropriate billing time increments,

`(E) whether particular tasks were staffed appropriately,

`(F) whether the costs and expenses submitted by the collecting attorney were reasonable,

`(G) whether the collecting attorney exercised billing judgment, and

`(H) any other matters normally addressed by the legal auditing firm when reviewing attorney billings for private clients.

`(3) FILING OF REPORT; RESPONSE; BURDEN OF PROOF- The court shall set a date for the filing of the report of the legal auditing firm, and allow the collecting attorney or any applicable plaintiff to respond to the report within a reasonable time period. The report shall be presumed correct unless rebutted by the collecting attorney or any applicable plaintiff by clear and convincing evidence.

`(4) FEE FOR LEGAL AUDITING FIRM- The fee for the report of the legal auditing firm shall be paid from the collecting attorney's fee award, the applicable plaintiff's recovery, or both in a manner determined by the court.

`(i) REGULATIONS- The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this section, including regulations to prevent avoidance of the purposes of this section and regulations requiring recordkeeping and information reporting.'.

(b) CONFORMING AND CLERICAL AMENDMENTS-

(1) Subsections (a), (b), and (c) of section 4963 of the Internal Revenue Code of 1986 are each amended by inserting `4959,' after `4958,'.

(2) Subsection (e) of section 6213 of such Code is amended by inserting `4959 (relating to excess fee transactions),' before `4971'.

(3) Paragraphs (2) and (3) of section 7422(g) of such Code are each amended by inserting `4959,' after `4958,'.

(4) The heading for subchapter D of chapter 42 of such Code is amended to read as follows:

`Subchapter D--Failure by Certain Charitable Organizations and Persons to Meet Certain Qualification Requirements and Fiduciary Standards'.

(5) The table of subchapters for chapter 42 of such Code is amended by striking the item relating to subchapter D and inserting the following:

`SUBCHAPTER D. Failure by certain charitable organizations and persons to meet certain qualification requirements and fiduciary standards'.

(6) The table of sections for subchapter D of chapter 42 of such Code is amended by adding at the end the following new item:

`Sec. 4959. Taxes on excess fee transactions.'.

(c) EFFECTIVE DATE- The amendments made by this section shall apply to excess fees paid on or after June 1, 2002.

SEC. 3. DECLARATORY JUDGMENTS RELATING TO EXCISE TAXES ON EXCESS FEE TRANSACTIONS OF CERTAIN ATTORNEYS.

(a) IN GENERAL- Subchapter B of chapter 76 of the Internal Revenue Code of 1986 (relating to judicial proceedings) is amended by redesignating section 7437 as section 7438 and by inserting after section 7436 the following new section:

`SEC. 7437. DECLARATORY JUDGMENTS RELATING TO TAX ON EXCESS FEE TRANSACTIONS.

`(a) IN GENERAL- In a case of actual controversy involving--

`(1) a determination by the Secretary or the collecting attorney with respect to the imposition of the excise tax on excess fee transactions on such collecting attorney under section 4959, or

`(2) a failure by the Secretary or the collecting attorney to make such a determination,

upon the filing of an appropriate pleading by an applicable plaintiff, the Tax Court may make a declaration with respect to such determination or failure. Any such declaration shall have the force and effect of a decision of the Tax Court and shall be reviewable as such.

`(b) DEFERENTIAL REVIEW- If a collecting attorney's fee has been approved by a court in accordance with section 4959(c)(1)(D) or by the Secretary pursuant to section 4959, the Tax Court shall review the fee only for an abuse of discretion.

`(c) LEGAL AUDITING FIRM- In any petition for a declaration referred to in subsection (a):

`(1) NO PREVIOUS REPORT- If a report by a legal auditing firm that meets the requirements of section 4959(h) has not been previously produced and relied on by another court, the Tax Court shall hire such a legal auditing firm and rely on its report pursuant to the procedures in section 4959(h).

`(2) SECOND REPORT-

`(A) IN GENERAL- If a report by a legal auditing firm has been approved by a court in accordance with section 4959, the Tax Court shall hire a second legal auditing firm upon the request of the petitioner.

`(B) FEE FOR REPORT- The Tax Court may direct the petitioner to pay the fee for any report of a legal auditing firm provided pursuant to subparagraph (A).

`(d) TIME FOR BRINGING ACTION- No proceeding may be initiated under this section by any person until 90 days after such person first notifies the Secretary of the excess fee transaction with respect to which the proceeding relates.

`(e) DEFINITIONS- For purposes of this section, any term used in this section and also in section 4959 shall have the meaning given such term by section 4959.'.

(b) CLERICAL AMENDMENT- The table of sections for subchapter B of chapter 76 of the Internal Revenue Code of 1986 is amended by striking the item relating to section 7437 and by inserting the following new items:

`Sec. 7437. Declaratory judgments relating to tax on excess fee transactions.

`Sec. 7438. Cross references.'.

(c) EFFECTIVE DATE- The amendments made by this section shall apply to actions after the date of the enactment of this Act.

END

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ISCRAA: The Kyl-Cornyn Bill to Enforce Fiduciary Attorney Fee Standards in Mass Tort Litigation

The Intermediate Sanctions Compensatory Revenue Adjustment Act (ISCRAA) allows attorneys fees of no more than 500% of reasonable hourly rates in lawsuits resulting in judgments greater than $100 million. ISCRAA uses an existing provision of the tax code to enforce basic, universally accepted fiduciary standards governing the award of attorneys fees. To avoid punitive tax rates, an attorney would be required to restore the excessive portion of any fee to the client. Because ISCRAA applies to current and future fees paid pursuant to the state Medicaid tobacco litigation settlement, ISCRAA will restore approximately $9 billion to the states.

ISCRAA's Benefits:

- **Limiting speculative, fee-driven mass tort litigation.** The current mass-tort litigation crisis is driven in large part by the enormous and unethical fees commanded by some plaintiffs' attorneys. Because their fees are so grossly disproportionate to their actual efforts, these lawyers can pursue even speculative lawsuits that lack a legitimate foundation – even only an occasional victory produces massive profits. By requiring that fees be proportional to attorneys' actual work, ISCRAA inevitably will limit this type of litigation.

- **Enforcing Pre-existing Fiduciary Standards.** Attorneys undisputedly are fiduciaries who occupy a position of trust in their dealings with their clients. One obligation flowing from this status – a requirement that is established in the attorney ethics rules of all 50 states – is that a lawyer must not charge an unreasonable or excessive fee. Courts traditionally read a reasonableness requirement into every attorneys fee contract. ISCRAA does not change this pre-existing obligation – it simply makes the duty enforceable in large lawsuits.

- **Helping the States.** Because it applies to the fees still being paid in the state tobacco settlement, ISCRAA will restore approximately $9 billion to the states. Tobacco companies will pay the same amount – but continuing excess fees will be restored to the clients (the states), not to lawyers who violated their fiduciary duties. Under ISCRAA, even our nation's smallest state, Wyoming, would recoup at least $15 million, and other small states, such as North Dakota, would receive approximately $20 million. Our nation's largest state, California, can expect to recoup at least $1 billion. Other large states would also see generous returns: Florida, $511 million; Illinois, $397 million; Michigan, $318 million; New York, $607 million; Ohio, $363 million; and Texas, $667 million.

- **Guaranteeing Mass-Tort Plaintiffs Access to Counsel**. ISCRAA's fee formula is as generous as the most liberal limits adopted by state courts, and considerably more generous than the limits that federal courts have applied in $100 million cases. ISCRAA protects fiduciary interests, while providing plaintiffs' lawyers with ample incentive to provide high-quality legal representation in large lawsuits.

What Plaintiffs' Lawyers and Anti-Tobacco Activists Are Saying About the Tobacco-Settlement Attorneys Fees:

[From Senator Cornyn's Senate speech introducing ISCRAA]

There is widespread agreement that the fees awarded in the tobacco settlement are excessive and unreasonable. Perhaps the most damning indictments come from those who took the plaintiffs' side in this litigation – including from plaintiffs' lawyers themselves.

- For example, Michael Ciresi, a pioneer in the tobacco litigation who represented the state of Minnesota in its lawsuit, and who is no doubt familiar with what these lawsuits actually require, has said that the Texas, Florida, and Mississippi lawyers' fee awards "are far in excess of these lawyers' contribution to any of the state results."[1]

- Similarly, former Food and Drug Administration Commissioner David Kessler, another leader in the fight against tobacco, has said that the states' private lawyers "did a real service, but I think the fee is outrageous. All the legal fees are out of control."[2]

- Washington, D.C. lawyer and tobacco-industry opponent John Coale has denounced the fee awards as "beyond human comprehension" and stated that "the work does not justify them."[3]

- Even the Association of American Trial Lawyers, the nation's premier representative of the plaintiffs bar, has condemned attorneys fees requested in the state tobacco settlement. The President of ATLA has noted:

  "Common sense suggests that a one billion dollar fee is excessive and unreasonable and certainly should invite the scrutiny [of the courts]. [ATLA] generally refrains from expressing an institutional opinion regarding a particular fee in a particular case, but we have a strong negative reaction to reports that at least one attorney on behalf of the plaintiffs in the Florida case is seeking a fee in excess of one billion dollars."[4]

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[1]Michael Ciresi, as quoted in Barry Meier, *Case Study in Tobacco Law: How a Fee Jumped in Days*, THE NEW YORK TIMES, December 15, 1998, at A16.

[2]David A. Kessler, as quoted in Barry Meier, *Case Study in Tobacco Law: How a Fee Jumped in Days*, THE NEW YORK TIMES, December 15, 1998, at A16.

[3]Robert Levy, *Hired Guns Corral Contingent Fee Bon*, LEGAL TIMES, February 1, 1999.

[4]Letter from Richard D. Hailey, President, Association of Trial Lawyers of America, to Rep. Howard Coble, R-NC (quoted in *Fla. Lawyers Attacked by Peers; Trial Association Says Fees Excessive; Smoke under Fire,* RICHMOND TIMES-DISPATCH, Wednesday, December 10, 1997, at A7.)

This letter, written in 1997, only concerned one of the Florida lawyers' request for attorneys fees. Ultimately, Florida's private counsel was awarded a total of $3.4 billion in fees. These statements demonstrate beyond all doubt that there is real abuse going on here, and that the victim of this abuse is the client, the plaintiff – and not the defendant.

- Perhaps the best gloss on the tobacco fee awards is that provided by Professor Lester Brickman, a professor of law at Cardozo Law School and noted authority on legal ethics and attorneys fees. Professor Brickman has stated:

  "Under the rules of legal ethics, promulgated partly as a justification for the legal profession's self-governance, fees cannot be 'clearly excessive.' Indeed, that standard has now been superseded in most states by an even more rigorous standard: fees have to be 'reasonable.' Are these fees, which in many cases amount to effective hourly rates of return of tens of thousands – and even hundreds of thousands – of dollars an hour, reasonable? I think to ask the question is to answer it."[5]

The attorneys fees awarded in the state tobacco settlement are simply indefensible. And the process by which the fees were awarded partly explains how they came to be so. Outside counsel fees were determined by a private arbitration panel established by the Master Settlement Agreement (MSA) that resolved 46 of the states' litigation. (Four other states had settled their suits earlier. Their lawyers, however, also were paid out of the accounts created by the MSA.) Amazingly, the settlement agreement explicitly immunized all fee awards from judicial review. Even more amazingly, one of the three arbitrators who made the awards had a clear conflict of interests: he was the father of a South Carolina lawyer whose law firm has received the largest fee awards of all, believed to amount to over $2 billion. Another one of the arbitrators had no background in fee arbitrations or any related matter, and simply ignored the law in order to make outrageous awards, using the salaries of sports stars and entertainers as a basis of measure. The third arbitrator, a retired federal judge appointed by President Carter, dissented from the key fee decisions.

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[5]Professor Lester Brickman, *The Tobacco Litigation and Attorneys' Fees*, 67 FORDHAM L. REV. 2827, 2830 (1999).

ISCRAA: RESTITUTION TO THE STATES

Under the terms of the November 1998 Master Settlement Agreement (MSA) between the states and tobacco companies, $500 million in cigarette taxes is set aside every year to pay the plaintiffs' attorneys who chose to have their fees awarded in arbitration. Because extraordinarily high fees were awarded by the arbitrators – estimated to total $15 billion – the $500-million-a-year income stream (which is not adjusted for inflation) may have to be paid in perpetuity. In addition to this annuity, the MSA also sets aside an additional $1.25 billion in cigarette taxes to compensate those lawyers who choose to forego arbitration and negotiate their fees directly with the tobacco companies.

The present value of the $500-million-a-year fee stream – discounting all future payments for the time value of money – has been conservatively estimated at just over $8 billion. Current and future payments from the $1.25 billion fee fund are less certain, since the grants made from that fund and their disbursement schedule have been kept obscure from the public. Because ISCRAA's effective date is June 1, 2002, ISCRAA will probably recoup for the states an additional $1 billion above the present value of future $500 million-a-year payments. ISCRAA does not affect the first three-and-a-half years of fees paid under the MSA. Because these payments almost certainly are adequate to pay all reasonable fees incurred in the litigation, ISCRAA would restore to the states virtually all fees paid after its effective date. Thus the net present value of the sums that ISCRAA would provide to the states can conservatively be estimated at $9 billion.

By restoring these excess fee payments to the states' MSA escrow account and returning them to the states on a per capita basis, ISCRAA guarantees every state a very substantial recovery. Based on the estimates that I have described, even our nation's smallest state, Wyoming, would recoup at least $15 million in tobacco fee payments, and other small states, such as North Dakota, would receive approximately $20 million. On the other hand, our nation's largest state, California, can expect to recoup at least $1 billion. Other large states would also see generous returns: Florida, $511 million; Illinois, $397 million; Michigan, $318 million; New York, $607 million; Ohio, $363 million; and Texas, $667 million.

Here is how much each state can expect to recover:

United States	*$9 billion*
Alabama	142,220,272
Alaska	20,049,569
Arizona	164,079,935
Arkansas	85,496,543
California	1,083,230,642
Colorado	137,556,275
Connecticut	108,911,511
Delaware	25,059,883
District of Columbia	18,294,706
Florida	511,123,686
Georgia	261,806,474
Hawaii	38,745,502
Idaho	41,381,203
Illinois	397,174,614
Indiana	194,456,664
Iowa	93,585,167
Kansas	85,976,825
Kentucky	129,257,603
Louisiana	142,919,876
Maine	40,772,615
Maryland	169,384,021
Massachusetts	203,046,997
Michigan	317,835,940
Minnesota	157,327,166
Mississippi	90,973,451
Missouri	178,937,382
Montana	28,852,605
Nebraska	54,726,966
Nevada	63,905,164
New Hampshire	39,520,996
New Jersey	269,094,724
New Mexico	58,173,915
New York	606,875,689
North Carolina	257,420,675
North Dakota	20,537,847
Ohio	363,078,559
Oklahoma	110,353,478
Oregon	109,417,889
Pennsylvania	392,753,669
Rhode Island	33,525,716
South Carolina	128,305,961
South Dakota	24,140,253
Tennessee	181,945,847

Texas	666,850,647
Utah	71,417,756
Vermont	19,470,563
Virginia	226,374,115
Washington	188,496,659
West Virginia	57,831,660
Wisconsin	171,532,756
Wyoming	15,791,372

SENATOR KYL
INTRODUCTION OF ISCRAA

Mr. KYL: I rise today to introduce the Intermediate Sanctions Compensatory Revenue Adjustment Act of 2003 (ISCRAA). This legislation will restore to the states billions of dollars in revenue due to them from a massive lawsuit recently conducted on their behalf – the tobacco-related Medicaid expenses litigation. ISCRAA amends an existing provision of the federal tax code in order to enforce basic, universally accepted fiduciary standards governing the award of attorneys fees. By applying these standards to the attorneys who represented the states in the tobacco settlement, ISCRAA reasonably can be expected to restore to the states income with a present value of approximately $9 billion. I have included at the end of my statement a chart detailing how much each state can expect to recover.

ISCRAA's tax formula is borrowed from the 1996 Tax Act's Intermediate Sanctions Tax (IST), which applies a two-step excise tax to any excessive or unreasonable compensation that the managers of a trust pay to themselves from the assets of the trust. The IST framework encourages the trustee to restore the excessive portion of any fee to the trust – when he does so, the IST's punitive taxes do not apply.

ISCRAA extends the IST to another type of trust relationship: that between a lawyer and his client. ISCRAA applies the IST tax formula to any unreasonable or excessive income that a lawyer collects from litigation resulting in a judgment or settlement in excess of $100 million. To avoid IST taxes, an attorney must restore the excessive portion of the fee to the client.

As my colleague Senator CORNYN will explain today, the ethical and legal abuses that resulted from the 1998 state tobacco settlement make the need for this legislation manifest. Senator CORNYN also will discuss the law of attorneys' fiduciary obligations, which establishes that a fee award is the property of the client – and that any unethical fee must be restored to the client, regardless of how the fee award is structured.

I will discuss today how ISCRAA will affect massive litigations generally. In order to gauge the reasonableness of a lawyer's fee award, ISCRAA adopts and codifies a liberal version of the lodestar-multiplier system. As I will later explain in greater detail, ISCRAA allows fee multipliers of up to 500% of reasonable hourly rates. This limit is as generous as the most liberal limits adopted by state courts, and considerably more generous than the limits that federal courts have applied in $100 million cases. ISCRAA's fee formula guarantees that attorneys' fiduciary obligations will be respected, while providing plaintiffs lawyers with ample incentive to provide high-quality legal representation in these types of cases.

Massive Litigations and the Prospect of Tax Farming

Federal supervision of fee awards resulting from $100 million litigations is appropriate for several reasons. First, because of their shear size, these types of lawsuits inevitably operate as a tax on the consuming public. Few defendants actually can afford to pay such judgments with

cash on hand. Instead, the affected industries simply will raise the prices that they charge to their customers.

This is exactly what has happened in the state Medicaid tobacco settlement – according to the leading proponents of that litigation. The first state attorney general to file suit against the tobacco companies has admitted that "what always happens in these cases is the industry passes the costs to the consumer."[1] Other commentators agree that this has occurred in the tobacco litigation. As one law-review article notes, "the [tobacco] settlement * * * is a tax because it's a set of payments made by tobacco companies that depend on how many packs they sell; in short, it looks like a tax and quacks like a tax."[2]

Because of the way that these massive judgments typically are satisfied, it is particularly important to ensure that attorneys are paid in proportion to the services that they provided – rather than solely on the basis of the size of the recovery. Again, the state tobacco settlement highlights the nature of the problem. As two of the leading academic commentators have noted, it is "very troubl[ing]" that under that agreement, "a group of private citizens [are] getting paid a percentage of a tax increase they helped pass."[3] The shear size of the tobacco settlement – and the fact that attorneys fees were based on this size, rather than on the attorneys' actual efforts – has given the fee awards an uncanny resemblance to the medieval practice of tax farming. In all but name, the government has licensed a group of private individuals to collect a tax from the consuming public.

I would emphasize at this point that ISCRAA is not an attack on the state tobacco lawsuits. The bill does not pass judgment on the merits or the appropriateness of this type of litigation. ISCRAA simply is designed to ensure that when such lawsuits are brought on the public's behalf, the public receive its fair share of the proceeds. If a state chooses to seek compensatory revenue from industry for past harms, then the resulting tax on the public – minus the reasonable value of the legal services actually provided – must go to the state treasury.

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[1]Michael Moore, Attorney General of Mississippi (quoted in *Law Firms Reap $1.4 Billion*, THE SUN HERALD (Biloxi, MS), July 30, 1999, Page A1). *See also* Margaret A. Little, *A Most Dangerous Indiscretion: the Legal, Economic, and Political Legacy of the Governments' Tobacco Litigation*, 33 U. CONN. L. REV. 1143, 1180 (2001) ("We did not take this case for fees, nor did we intend to raise taxes or put the states in partnership with tobacco. There is a danger that this is happening, though, and I'm not sure how to stop it") (quoting Richard Scruggs, Mississippi tobacco plaintiffs lawyer).

[2]Margaret A. Little, *A Most Dangerous Indiscretion: the Legal, Economic, and Political Legacy of the Governments' Tobacco Litigation*, 33 U. CONN. L. REV. 1143, 1180 (2001).

[3]Jeremy Bulow & Paul Klemperer, *The Tobacco Deal*, BROOKINGS PAPERS ON ECONOMIC ACTIVITY, January 1, 1998.

$100 Million Lawsuits Are Different

There are several reasons why $100 million is an appropriate threshold for applying ISCRAA's fee formula. First, the courts themselves have indicated that fee agreements based primarily on the size of the recovery tend to become unreasonable when judgements reach this size. As one court has stated, "in much smaller cases, a fee award of 33% does not present the danger of providing the plaintiff's counsel with the windfall that would accompany a 'megafund' settlement of $100 million or upwards. But it is quite different when the figures hit the really big time."[4] Or as the Third Circuit notes, "courts have generally decreased the percentage awarded [for attorneys fees] as the amount recovered increases, and $100 million seems to be the informal marker of a 'very large' settlement."[5]

The logic of avoiding judgment-based awards in these very large cases is straightforward. As one court explains, "it is not 150 times more difficult to prepare, try, and settle a $150 million case than it is to try a $1 million case, but the application of a percentage comparable to that in a smaller case may yield an award 150 times greater."[6] Thus (according to another court) "there is considerable merit" to disallowing standard percentage awards as the "size of the [recovery] fund increases. In many instances the increase [in the recovery] is merely a factor of the size of the class and has no direct relationship to the efforts of counsel."[7]

It also bears mention that because of its $100 million threshold, ISCRAA applies to a fairly limited universe of cases. As courts have remarked, "there are few so-called 'megafund' cases with settlements over $100 million."[8] In 2001, the U.S. Court of Appeals for the Third Circuit

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[4] *In re Synthroid Marketing Litig.*, 110 F.Supp.2d 676, 684 (N.D. Ill. 2000) (*rev'd on other grounds, In the Matter of Synthroid Marketing Litig.*, 264 F.3d 712 (7th Cir. 2001)).

[5] *In re Cendant Corp. PRIDES Litig.*, 243 F.3d 722, 736 n.19 (3d Cir. 2001). *See also* Herbert P. Newberg, NEWBERG ON CLASS ACTIONS, § 14.03 at 190 (1985) ("the fee percentage would be significantly more modest as the common fund recovery begins to reach recoveries approaching or exceeding $100 million").

[6] *In re Synthroid Marketing Litig.*, 201 F.Supp.2d 861 (N.D. Ill. 2002). *See also Goldberger v Integrated Resources, Inc.*, 209 F.3d 43, 52 (2d Cir. 2000) ("Obviously, it is not ten times more difficult to prepare, and try or settle a 10 million dollar case as it is to try a 1 million dollar case").

[7] *In re Unisys Corp. Retiree Medical Benefits ERISA Litig.*, 886 F.Supp 445, 464 (E.D.Pa. 1995).

[8] *In re Synthroid Marketing Litig.*, 201 F.Supp.2d 861, 864 (N.D. Ill. 2002). Initial research reveals that in cases where the fund is between $100 and $200 million, fees typically range from 4%-10%." *See also In re Unisys Corp. Retiree Medical Benefits ERISA*

attempted to catalogue all common-fund cases in federal court that resulted in recoveries greater than $100 million. Though such litigations have been more frequent in recent years, the Third Circuit identified only 22 such cases since 1985. *See in re Cendant Corp. PRIDES Litig.*, 243 F.3d 722, 737 (3d Cir. 2001).

ISCRAA is somewhat broader than the criteria that *Cendant Corp.* employed to collect cases. ISCRAA is not limited to common-fund cases – it also applies to judgments won on behalf of tax-exempt entities or even single individuals. ISCRAA also applies to cases brought in state court, and it aggregates identical claims that are brought against common defendants in separate actions, in order to prevent evasion of its limits through the subdivision of actions. Nevertheless, ISCRAA's scope remains fairly narrow. An academic specialist who is familiar with developments in this field has reviewed the bill and concluded that because of its "relatively high threshold," ISCRAA probably would apply only to about 15-20 litigations per year. I will include a copy of this professor's letter to me in the congressional record.

Finally, a $100 million threshold also is appropriate because it limits ISCRAA's reach to litigations that are a natural subject of congress's authority to regulate interstate commerce. It is well-established that "Congress' commerce authority includes the power to regulate * * * those [economic] activities that substantially affect interstate commerce." *United States v. Morrison*, 529 U.S. 598, 609 (2000). *See also United States v. Lopez*, 514 U.S. 549 (1995). Both the executive and the legislative branches previously have identified $100 million as guideline for determining whether a matter has a significant impact on interstate commerce. *See, e.g.* Executive Order 12866; Congressional Review Act, 5 U.S.C. § 804(2); Unfunded Mandates Act, 2 U.S.C. § 1532(a). Because it is limited to litigations of this size, ISCRAA is consistent with congress's power and obligation to protect the flow of commerce between states.

Guaranteeing Adequate Incentives to Plaintiffs' Lawyers

Another point that I would like to emphasize today is that ISCRAA is not an anti-plaintiffs' lawyer bill. It is not stingy toward trial attorneys. ISCRAA is carefully designed to protect fiduciary interests while providing plaintiffs' lawyers with ample incentives to provide high-quality legal representation in large litigations. ISCRAA's fee formula is as generous as the limits set by the most liberal state courts that engage in meaningful review of attorneys fees, and is considerably more generous than the federal courts' practices in $100 million cases. Moreover, the multiplier criteria that ISCRAA employs universally are recognized as legitimate prerequisites for a contingency fee – even by trial lawyers' professional associations.

Federal courts primarily rely on two systems for calculating attorneys fees in cases (such as class actions) in which they are required to set "reasonable fees:" the percentage method and the lodestar-multiplier method. The percentage method, as its name implies, calculates fees as a

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Litig., 886 F.Supp 445, 462 (E.D.Pa. 1995) ("The number of cases involving a common fund in the neighborhood of [$100 million] is relatively small").

percentage of the total recovery. The lodestar system, by contrast, requires a court to first calculate a fee based on the number of hours that the lawyer worked multiplied by prevailing hourly rates (the "lodestar"). The court then multiplies this lodestar fee again in order to reward the attorney for the risk of nonpayment of fees that he assumed and for any exceptional services that he provided.

Over the last thirty years, courts have moved back and forth between these two systems.[9] Only a few courts make lodestar-multipliers the *exclusive* means of awarding attorneys fees. But as one academic commentator has noted, "lodestar, or hours-based methods, have been adopted in every [federal judicial] circuit."[10]

And more importantly, in large-recovery cases, there has been very little difference between lodestar and percentage systems. This is because even when courts apply a percentage to calculate fees, and as judgements become very large, courts typically also calculate a reasonable lodestar in order to determine what constitutes a reasonable percentage. Thus, again, as the Third Circuit notes, "courts have generally decreased the percentage awarded as the amount recovered increases, and $100 million seems to be the informal marker of a 'very large' settlement."[11]

Courts have been wary of awarding fees based on percentages alone. As one state supreme court explains:

> "to begin the assessment by arbitrarily picking a percentage amount without any reliance on a cognizable structure invites decisions that are nonobjective and inconsistent. What constitutes a reasonable percentage may differ from one judge to another depending on each judge's predilections, background, and geographical location in the state."[12]

Thus "courts that employ the percentage approach appear to be motivated in part by a lodestar dynamic. Because courts are reluctant to give fee awards totally incommensurate with the efforts

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[9] *See In re Cendant Corp. PRIDES Litig.*, 243 F.3d 722 (3d Cir. 2001).

[10] Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STANFORD L. REV. 497, 538 n.160 (1991) (citing cases). *See also Goldberger v. Integrated Resources, Inc.*, 209 F.3d 43, 49 (2d Cir. 2000) (noting that in addition to Second Circuit, "six other circuits have reaffirmed that district courts enjoy the discretion to use either the lodestar or the percentage method") (citing cases).

[11] *In re Cendant Corp. PRIDES Litig.*, 243 F.3d 722, 736 n.19 (3d Cir. 2001).

[12] *Kuhnlein v. Dep't of Revenue*, 662 So.2d 309, 313 (Fla. 1995).

of the attorneys, percentage awards generally decrease as the amount of the recovery increases."[13]

One result of the cross-use of the lodestar and percentage systems is that even when courts use the percentage system, those awards overwhelmingly tend to reflect a reasonable lodestar multiplier. Therefore, even percentage-based cases tend to provide evidence of the range of multipliers that the courts consider to be reasonable.

In 2001, the Third Circuit "set forth a chart of fee awards given in federal courts since 1985 in class actions in which the settlement fund exceeded $100 million and in which the percentage of recovery method was used."[14] (*Cendant Corp.*) The court identified 17 such cases. In almost every case, the Third Circuit could calculate the multiplier that was used, and "the lodestar multiplier in those cases never exceeded 2.99." And in the direct lodestar-multiplier cases that court identified, the multiplier ranged from 1.2 to 3.25.[15]

Other courts, surveying smaller cases than the $100 million recoveries examined in *Cendant Corp.*, have identified larger multipliers. One federal district court has "observe[d] that in virtually every case where the court notes a lodestar but awards fees based upon a percentage, the lodestar multiplier converted from this percentage is in the range of 1 to 4."[16] Another federal district court has found that "the range of lodestar multipliers in large and complicated class actions runs from a low of 2.26 to a high of 4.5."[17]

By contrast, some courts have declared that they would allow only lower multipliers. One federal court has stated that "only in the most exceptional circumstances would this court award a multiplier of 3 or greater. * * * this court believes that lodestars enhanced by multipliers less

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[13]*In re Unisys Corp. Retiree Medical Benefits ERISA Litig.*, 886 F.Supp 445, 463 (E.D.Pa. 1995). *See also Goldberger v Integrated Resources, Inc.*, 209 F.3d 43, 50 (2d Cir. 2000) ("the lodestar remains useful as a baseline even if the percentage method is chosen. Indeed, we encourage the practice of requiring documentation of hours as a 'cross check' on the reasonableness of the requested percentage").

[14]*In re Cendant Corp. PRIDES Litig.*, 243 F.3d 722, 737 (3d Cir. 2001).

[15]*See id.* at 737 n.22.

[16]*In re Unisys Corp. Retiree Medical Benefits ERISA Litig.*, 886 F.Supp 445, 464 n.36 (E.D.Pa. 1995).

[17]*Behrens v. Wometco Enterprises, Inc.*, 118 F.R.D. 534, 549 (S.D.Fla.1988).

than 3 should adequately compensate even the most talented counsel."[18] And the Seventh Circuit has suggested that "it may be that a doubling of the lodestar would provide a sensible ceiling."[19]

On the other hand, the Florida Supreme Court – which is generally regarded as one of the more plaintiff-friendly courts in the United States – has announced that:

> "we set the maximum multiplier available in this common-fund category of cases at 5. * * * * [A] multiplier which increases fees to five times the accepted hourly rate is sufficient to alleviate the contingency risk factor involved and attract high level counsel to common fund cases while producing a fee that remains within the bounds of reasonableness. We emphasize that 5 is a maximum multiplier."[20]

ISCRAA adopts this more liberal standard. It allows fees as high as 500% of reasonable hourly rates. ISCRAA awards multipliers based on two criteria: it allows up to 300% to be added onto the amount of reasonable hourly fees if a case that involved a substantial risk of nonrecovery of fees, and allows an additional 100% add-on if the attorney provided exceptional services that improved the plaintiff's recovery.

The criteria that ISCRAA employs universally are recognized as necessary prerequisites to the legitimacy of a contingency fee. "Courts in general have insisted that a contingent fee be truly contingent. The typically elevated fee reflecting the risk to the lawyer of receiving no fee will be permitted only if the representation indeed involves a significant degree of risk." Charles W. Wolfram, MODERN LEGAL ETHICS § 9.4, at 532 (1986). The risk requirement has been recognized ever since contingency fees first were allowed in the United States. The American Bar Association even noted at that time that "a contract for a contingent fee, where sanctioned by law, should be reasonable under all the circumstances of the case, including the risk and uncertainty of the compensation." ABA CANONS OF PROFESSIONAL ETHICS, Canon 13 (1908). Indeed, even the professional associations of plaintiffs' attorneys have, at times, acknowledged that contingent fees should be based on an actual contingency. In a guide to its members, the Association of Trial Lawyers of America has "recommend[ed]" that attorneys "exercise sound judgment in using a percentage in the contingent fee contract that is commensurate with the risk, cost and effort required." ATLA, KEYS TO THE COURTHOUSE: QUICK FACTS ON THE CONTINGENCY FEE SYSTEM 13 (1994).

The criteria that ISCRAA employs are universally accepted – and the limits that it sets should be universally acceptable. ISCRAA is not intended to *alter* the considered standards of any

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[18] *In re Unisys Corp. Retiree Medical Benefits ERISA Litig.*, 886 F.Supp 445, 482 (E.D.Pa. 1995).

[19] *Skelton v. General Motors Corp.*, 860 F.2d 250, 258 (7th Cir. 1988).

[20] *Kuhnlein v. Dep't of Revenue*, 662 So.2d 309, 315 (Fla. 1995) (emphasis in original).

jurisdiction. Rather, it is intended to *enforce* those standards – and to correct the occasional extreme outlier. Because ISCRAA incorporates a fee formula that is substantially more liberal than the usual practices of the federal courts in $100 million cases, we can be confident that high-quality legal representation will remain available to plaintiffs in these large litigations. *See, e.g. in re Sumitomo Copper Litig.*, 74 F. Supp. 2d 393 (S.D.N.Y. 1999) (RICO and Commodities Exchange Act case resulting in $116 million recovery; attorneys reviewed millions of pages of documents located throughout the world, many requiring translation from Japanese; federal district court awards multiplier of 250% for total fee of $32 million).

Fiduciary Restraints on Attorney Fee Contracts

Another issue that I will address today is the argument – occasionally raised in opposition to proposals to limit attorneys fees – that such restrictions violate attorneys' rights to freedom of contract.

The first principle to keep in mind when questions of attorneys fees are considered is that "a fiduciary relationship exists as a matter of law between attorney and client."[21] (Illinois Supreme Court.) As one academic commentator has noted:

> "[I]t is uncontroverted today that a lawyer is a fiduciary for, and therefore has a duty to deal fairly with, the client. * * * * Lawyers are fiduciaries because retention of an attorney to exercise 'professional judgement' on the client's behalf necessarily involves reposing trust and confidence in the attorney. Exercising professional judgment requires that the lawyer advance the client's interests as the client would define them if the client were well-informed."[22]

The lawyer's status as fiduciary places limits on his dealings with his client – including with regard to his fee. "An attorney's freedom to contract with a client is subject to the constraints of ethical considerations."[23] (New Jersey Supreme Court.) "In setting fees, lawyers are fiduciaries who owe their clients greater duties than are owed under the general law of contracts."[24] (Massachusetts Appeals Court.) "As a result of lawyers' special role in the legal system,

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[21] *Gaffney v. Harmon*, 90 N.E.2d 785, 788 (Ill. 1950). *See also* Charles Wolfram, MODERN LEGAL ETHICS § 4.1, at 146 (1986) ("the designation of 'fiduciary,' * * * surely attaches to the [lawyer-client] relationship").

[22] Lester Brickman, "Contingent Fees Without Contingencies: Hamlet Without the Prince of Denmark?," 37 U.C.L.A. L. REV. 29, 45-46 (1989).

[23] *Cohen v. Radio-Electronics Officers Union, Dist. 3*, 679 A.2d 1188, 1195-96 (N.J. 1996).

[24] *Garnick & Scudder, P.C. v. Dolinsky*, 701 N.E.2d 357, 358 (Mass. App. 1998).

contracts between lawyer and client receive special scrutiny. * * * * While freedom of contract is the guiding principle underlying contract law, contractual freedom is muted in the lawyer-client and lawyer-lawyer contexts."[25] (Joseph M. Perillo, law professor.)

The unique status of attorney fee contracts has led courts to reject analogies between such agreements and other business or service contracts. Perhaps the fullest exposition is provided by the Arizona Supreme Court:

> "We realize that business contracts may be enforced between those in equal bargaining capacities, even though they turn out to be unfair, inequitable or harsh. However, *a fee agreement between lawyer and client is not an ordinary business contract*. The profession has both an obligation of public service and duties to clients which transcend ordinary business relationships and prohibit the lawyer from taking advantage of the client. Thus, in fixing and collecting fees the profession must remember that it is a branch of the administration of justice and not a mere money getting trade.' ABA CANONS OF PROFESSIONAL ETHICS, Canon 12."[26]

The same principle has been identified by the Florida Supreme Court:

> "*There is but little analogy between the elements that control the determination of a lawyer's fee and those which determine the compensation of skilled craftsmen in other fields*. Lawyers are officers of the court. The court is an instrument of society for the administration of justice. Justice should be administered economically, efficiently, and expeditiously. The attorney's fee is, therefore, a very important factor in the administration of justice, and if it is not determined with proper relation to that fact it results in a species of social malpractice that undermines the confidence of the public in the bench and bar. It does more than that. It brings the court into disrepute and destroys its power to perform adequately the function of its creation."[27]

In order to protect the lawyer's public role and to enforce his fiduciary obligations, the courts read a reasonableness requirement into every attorney fee contract. "[T]he requirement that a fee

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[25]Joesph M. Perillo, *The Law of Lawyers' Contracts is Different*, 67 FORDHAM L. REV. 443, 445 (1998).

[26]*In the Matter of Swartz*, 686 P.2d 1236, 1243 (Ariz. 1984) (emphasis added).

[27]*Kuhnlein v. Department of Revenue*, 662 So.2d 309, 313 (Fla. 1995) (emphasis added). *See also Gruber & Coabella, P.A. v. Erickson*, 784 A.2d 758, 760 (N.J.Sup.Ct. 2001) ("Attorneys have never had the right to enforce contractual provisions for more than a fair and reasonable fee. They are not businessmen entitled to charge what the traffic will bear").

be reasonable in amount overrides the terms of the contract, so that an 'unreasonable' fee cannot be recovered, even if agreed to by the client." G. Hazard, Jr. & W. Hodes, THE LAW OF LAWYERING 1. 5:205 *Fee Litigation and Arbitration* 120 (1998 Supp.).

As one court has stated,

> "[A]n attorney is only entitled to fees which are fair and just and which adequately compensate him for his services. This is true *no matter what fee is specified in the contract*, because an attorney, as a fiduciary, cannot bind his client to pay a greater compensation for his services than the attorney would have the right to demand if no contract had been made. Therefore, as a matter of public policy, *reasonableness is an implied term* in every contract for attorney's fees."[28]

Finally, when assessing whether a fee is reasonable, courts ask whether the fee is proportional to the services that were actually provided. "Fees must be reasonably proportional to the services rendered and the situation presented."[29] (Arizona Supreme Court.) "If an attorney's fee is grossly disproportionate to the services rendered and is charged to a client who lacks full information about all of the relevant circumstances, the fee is 'clearly excessive' * * * even though the client consented to such fee."[30] (West Virginia Supreme Court.)

Because attorneys are fiduciaries, they simply do not have complete freedom of contract in negotiating their fees. An attorney's dealings with his client always must reflect that the client comes to him in a position of trust – and therefore, the attorney's fee always must be reasonable. ISCRAA will help ensure that this important obligation is respected.

ISCRAA's Effective Date

Another subject that I would like to address today is ISCRAA's effective date. ISCRAA applies to attorney fee payments received after June 1, 2002. This effective date is appropriate under the circumstances of the state tobacco settlement for several reasons: first, Congress routinely enacts major tax legislation with effective dates that look back much further than does ISCRAA. The

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[28] *Missouri ex rel. Chase Resorts, Inc. v. Campbell*, 913 S.W.2d 832 (Mo. App. 1996) (emphasis added). *See also* G. Hazard, ETHICS IN THE PRACTICE OF LAW 99 (1978) ("A contract for a [legal] fee is, under general principles of law, a contract between a fiduciary and his protected dependent * * * [and] it is unenforceable unless its terms are fair to the client"); *Trinkle v. Leeney*, 650 N.E.2d 749, 754 (Ind.Ct.App.1995) ("Under no circumstances is a lawyer entitled to more than the reasonable value of his or her services. [Moreover,] [r]easonable fees are not necessarily determined by the terms of the attorney-client contract").

[29] *In the Matter of Struthers*, 877 P.2d 789, 796 (Ariz. 1994).

[30] *Committee on Legal Ethics v. Tatterson*, 352 S.E.2d 107, 113 (W. Va. 1986).

Supreme Court has "repeatedly upheld [such moderately] retroactive tax legislation against a due process challenge." *United States v. Carlton*, 512 U.S. 26, 30-31 (1994); *see id.* at 33 (upholding tax whose "actual retroactive effect * * * extended for a period only slightly greater than one year").

Second, ISCRAA is not even truly retroactive. ISCRAA does not change the *substantive* law governing attorneys fee awards. Rather, it simply enforces established, *pre-existing* fiduciary standards that already bind every attorney in every state. The MODEL RULES OF PROFESSIONAL CONDUCT, at Rule 1.5(a), contain a clear, direct command that "a lawyer's fee shall be reasonable." Similarly, the MODEL CODE OF PROFESSIONAL RESPONSIBILITY, at DR 2-106, directs that an attorney "shall not enter into an agreement for, charge, or collect an illegal or clearly excessive fee." The Model Code further explains that an attorneys fee is "clearly excessive when, after a review of the facts, a lawyer of ordinary prudence would be left with a definite and firm conviction that the fee is in excess of a reasonable fee." Finally, as academic commentators point out, in addition to the model rules, "*all state rules of professional conduct* prohibit attorneys from charging excessive fees."[31] (Emphasis added.)

As I described earlier, to enforce fiduciary standards, ISCRAA codifies and applies a very generous version of the fee multiplier system, allowing attorneys fees as high as 500% of reasonable hourly rates. This is considerably more generous than what federal courts typically allow in large-judgment cases. No attorney can be heard to complain that he is subjected to a law that is more generous than his existing fiduciary obligations.

Further, none of the tobacco-settlement attorneys can reasonably maintain that they have a vested right to see their fiduciary duties to the states go unenforced. Nevertheless, in order to be fair to all parties, ISCRAA's excise taxes are applied only to fees that were paid after June 1, 2002. By this date, all of the tobacco lawyers *twice* had received notice from George W. Bush that he intended to enact legislation to enforce their fiduciary obligations. In February 2000, then-candidate Bush promised that he would "extend[] the 'excess benefits' provision of the tax code to private lawyers who contract with states and municipalities," with "the reasonableness of the fees * * * [to] be determined by the standard judicial 'lodestar' method." And as early as February 2001, the current Administration announced that it anticipated providing "additional public health resources for the States from the President's proposal to extend fiduciary responsibilities to the representatives of States in tobacco lawsuits." *See* A BLUEPRINT FOR NEW BEGINNINGS: A RESPONSIBLE BUDGET FOR AMERICA'S PRIORITIES 80, Office of Management and Budget, February 28, 2001.

Under ISCRAA, all of the attorneys who participated in the state tobacco settlement still will be very liberally compensated. Because ISCRAA does not apply to the first three-and-a-half years

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[31] Vonde M. Smith Hitch, *Ethics and the Reasonableness of Contingency Fees: A Survey of State and Federal Law Addressing the Reasonableness of Costs as They Relate to Contingency Fee Agreements*, 29 LAND & WATER L. REV. 215, 218 n.22 (1994).

of fee payments under the settlement, it exempts the first two-and-a-half *billion* dollars that these lawyers received. Every one of the tobacco lawyers will have more than enough money left to pay for the yachts, luxury cars, and vacation homes that were purchased with the tobacco proceeds. ISCRAA might simply be described as the one-yacht-per-lawyer rule.

State Recovery of Excess MSA Payments

But most importantly, because ISCRAA applies to the last year's worth of tobacco fee payments, and to all future payments, it will return a substantial amount of funds to the states – money that already should belong to the states under any reasonable interpretation of fiduciary standards. It is critical that these funds be restored in this time of widespread fiscal crisis. Today a large number of the states face massive budget deficits that threaten their ability to provide health care to the indigent, to fully fund public education, and to guarantee adequate and effective law enforcement. When such needs risk going unmet, fee abuses that cost the states billions of dollars simply can no longer be ignored. The states must receive their fair share of the tobacco settlement proceeds – funds that are badly needed to support basic public services.

Under the terms of the November 1998 Master Settlement Agreement (MSA) between the states and tobacco companies, $500 million in cigarette taxes is set aside every year to pay the attorneys who chose to have their fees awarded in arbitration. Because extraordinarily high fees were awarded by the arbitrators – estimated to total $15 billion – the $500-million-a-year income stream (which is not adjusted for inflation) may have to be paid in perpetuity. In addition to this annuity, the MSA also sets aside an additional $1.25 billion in cigarette taxes to compensate those lawyers who choose to forego arbitration and negotiate their fees directly with the tobacco companies.

The present value of the $500-million-a-year fee stream – discounting all future payments for the time value of money – has been conservatively estimated at just over $8 billion. Current and future payments from the $1.25 billion fee fund are less certain, since the grants made from that fund and their disbursement schedule have been kept obscure from the public. Because ISCRAA's effective date is June 1, 2002, ISCRAA will probably recoup for the states an additional $1 billion above the present value of future $500 million-a-year payments. ISCRAA does not affect the first three-and-a-half years of fees paid under the MSA. Because these payments almost certainly are adequate to pay all reasonable fees incurred in the litigation, ISCRAA would restore to the states virtually all fees paid after its effective date. Thus the net present value of the sums that ISCRAA would provide to the states can conservatively be estimated at $9 billion.

By restoring these excess fee payments to the states' MSA escrow account and returning them to the states on a per capita basis, ISCRAA guarantees every state a very substantial recovery. Based on the estimates that I have described, even our nation's smallest state, Wyoming, would recoup at least $15 million in tobacco fee payments, and other small states, such as North Dakota, would receive approximately $20 million. On the other hand, our nation's largest state,

California, can expect to recoup at least $1 billion. Other large states would also see generous returns: Florida, $511 million; Illinois, $397 million; Michigan, $318 million; New York, $607 million; Ohio, $363 million; and Texas, $667 million.

Here is how much each state can expect to recover:

United States	*$9 billion*
Alabama	142,220,272
Alaska	20,049,569
Arizona	164,079,935
Arkansas	85,496,543
California	1,083,230,642
Colorado	137,556,275
Connecticut	108,911,511
Delaware	25,059,883
District of Columbia	18,294,706
Florida	511,123,686
Georgia	261,806,474
Hawaii	38,745,502
Idaho	41,381,203
Illinois	397,174,614
Indiana	194,456,664
Iowa	93,585,167
Kansas	85,976,825
Kentucky	129,257,603
Louisiana	142,919,876
Maine	40,772,615
Maryland	169,384,021
Massachusetts	203,046,997
Michigan	317,835,940
Minnesota	157,327,166
Mississippi	90,973,451
Missouri	178,937,382
Montana	28,852,605
Nebraska	54,726,966
Nevada	63,905,164
New Hampshire	39,520,996
New Jersey	269,094,724
New Mexico	58,173,915
New York	606,875,689
North Carolina	257,420,675
North Dakota	20,537,847
Ohio	363,078,559
Oklahoma	110,353,478
Oregon	109,417,889
Pennsylvania	392,753,669
Rhode Island	33,525,716
South Carolina	128,305,961

South Dakota	24,140,253
Tennessee	181,945,847
Texas	666,850,647
Utah	71,417,756
Vermont	19,470,563
Virginia	226,374,115
Washington	188,496,659
West Virginia	57,831,660
Wisconsin	171,532,756
Wyoming	15,791,372

SENATOR CORNYN

INTRODUCTION OF LANDMARK LEGISLATION TO COMBAT GROSSLY ABUSIVE ATTORNEY FEE AGREEMENTS

Wednesday, April 10, 2003

Mr. President, I am pleased to join my colleague, Senator Kyl, to introduce today this landmark legislation to clean up our civil justice system. This legislation would enact a badly needed reform to the way in which attorneys are paid in some of the nation's largest cases. It is designed to address some of the worst abuses of our civil justice system that I have witnessed in my nearly thirty years in the legal profession as a lawyer in private practice, as a state trial and appellate judge, and as state attorney general.

This legislation, the Intermediate Sanctions Compensatory Revenue Adjustment Act of 2003 (ISCRAA), will combat the gross abuse of attorney contingent fee agreements, abuses which we have been witnessing at an increasing rate in recent years. The legislation will enforce attorneys' fiduciary duties to their clients in a small but important category of cases – those resulting in judgments greater than $100 million.

Contingent fee agreements can have an important role to play in our civil justice system. Sometimes, when people are injured but cannot afford to hire lawyers out of their own pockets, attorneys will accept the case with the expectation that, if their clients prevail, the attorney will be paid for his or her services out of the judgment or settlement that the attorney is able to secure for the client. Such agreements between attorneys and their clients are called contingent fee agreements, because the attorney's fee is contingent on the client obtaining a money judgment or settlement. Contingent fee agreements, properly understood and utilized, reward attorneys for their work in obtaining monetary recovery for their clients, and the risk that they take that, despite their hard work and best efforts, they are unable to obtain any recovery for the client at all.

Contingent fees can thus help ensure that plaintiffs with legitimate claims have the opportunity to obtain justice from our courts through the assistance of counsel. But contingent fees also present serious ethical problems for our legal system – particularly when the dollar amounts at stake are extraordinary, especially when compared to the relatively light or even negligible effort and risk actually undertaken by the attorneys.

Clients hire attorneys with the understanding and expectation that the attorney is ethically, legally, and morally obliged to represent their best interests, and that the attorney will use his or her legal skills in order to produce the best possible result – not for the attorney, but for the client.

Thus, as my colleague has noted, contingent fee agreements are no ordinary agreements between consumers and businesses. It is a bedrock principle and well-established tenet of our Anglo-American system of justice that attorneys are not ordinary businessmen who can engage in hard bargaining with their customers, as courts have made clear on countless occasions. Rather, attorneys are officers of the court who have a fiduciary duty to their clients. As fiduciaries, attorneys occupy a position of trust in their dealings with their clients.

One obligation that flows from this status as a fiduciary is the attorney's obligation not charge an unreasonable or excessive fee. This obligation is a fundamental part of an attorney's ethical duties, universally recognized in the ethics rules of all 50 States. Courts have made clear, time and time again, that every attorney fee contract automatically and necessarily includes the requirement that the fee be a reasonable one, a requirement that no provision of such agreements

may abrogate.

ISCRAA affirms and reinforces the longstanding substantive law of attorneys' fiduciary duties, by providing a special mechanism to enforce those duties in a particularly high risk category of cases – a category that the courts themselves have singled out as posing special risks of unethical, windfall fees. Courts have noted that allowing standard contingency fee agreements in cases involving judgments of $100 million or more have a distinct tendency of grossly overcompensating attorneys for their actual services rendered.

ISCRAA prevents attorneys from evading their obligation to charge a reasonable fee in extraordinarily large recovery cases, by limiting awards to a generous multiple of reasonable hourly fees. State courts, federal courts, and even trial lawyers' themselves have all recognized that a reasonable fee must be proportional to the attorney's actual efforts. ISCRAA codifies and enforces this principle, while continuing to guarantee lawyers ample and generous compensation for their efforts – using fee multipliers that are as generous as the most liberal limits adopted by state courts, and which are considerably more generous than the limits set by federal courts in $100 million cases.

This legislation thus promises to clean up our civil justice system and to repudiate the grossest abuses of our legal system. Make no mistake: Although all attorneys are supposed to uphold a strict ethical code, under which they are strictly forbidden from charging their clients unreasonable or excessive attorney fees, the temptation to abuse contingent fee agreements is a strong one, and even more so when the dollar amounts are truly extraordinary – such as in the $100 million cases that would be covered by this legislation. And make no mistake: the victim of such attorney fee abuse, and the beneficiary of this legislation, is not the defendant who pays the judgment – after all, the defendant pays the same total amount whether the money goes to the attorney or to the client. Rather, the real victim of this abuse, and the real beneficiary of this legislation, is the injured client, whose money is being taken away from the lawyer through an abusive contingent fee arrangement.

As my colleague has also noted, ISCRAA is unquestionably an appropriate exercise of Congress's power to regulate and protect interstate commerce, especially considering the large size of the litigations to which it applies. $100 million is a standard threshold used by the federal government to determine whether an economic transaction significantly affects interstate commerce.

But the most important reason for federal intervention in this area I have not yet mentioned, and I would like to take a moment to discuss it here: the gross abuses that we have already witnessed in large litigation fee awards. Recent experience amply demonstrates that, if the federal government does not act to prevent unethical and grossly abusive fee awards in massive, nationwide lawsuits, no one will. Moreover, recent experience further demonstrates that unreasonable fee payments in such suits threaten not just the attorneys' fiduciary obligations; they also place at risk the integrity of our governmental institutions. The unwholesome incentives created by windfall, unethical fee awards in large-scale litigations have induced some public officials to abandon their civic obligations.

The textbook example of the types of abuses that make ISCRAA necessary is the attorneys fees awarded in the state lawsuits to recover tobacco-related Medicaid expenses. Individual law firms that represented the states in that litigation have been given hundreds of millions and sometimes even billions of dollars in fees. To date, approximately $15 billion in fees has been awarded to the tobacco settlement lawyers, to be paid out in $500-million-a-year increments. Attorneys representing just three of the states – Mississippi, Texas, and Florida – were awarded $8.2 billion in fees. In many cases, such fees were paid to attorneys who filed duplicate, copycat lawsuits at a time when settlement negotiations had already begun and the risk that the states would not

recover any money was negligible. Yet these lawyers nevertheless received massive contingency fees, for suits that involved no real contingency. And for most of the tobacco settlement lawyers, the size of the fee awards bears no reasonable relation to the actual effort expended or risk involved.

There is widespread agreement that the fees awarded in the tobacco settlement are excessive and unreasonable. Perhaps the most damning indictments come from those who took the plaintiffs' side in this litigation – including from plaintiffs lawyers themselves. For example, Michael Ciresi, a pioneer in the tobacco litigation who represented the state of Minnesota in its lawsuit, and who is no doubt familiar with what these lawsuits actually require, has said that the Texas, Florida, and Mississippi lawyers' fee awards "are far in excess of these lawyers' contribution to any of the state results."[1] Similarly, former Food and Drug Administration Commissioner David Kessler, another leader in the fight against tobacco, has said that the states' private lawyers "did a real service, but I think the fee is outrageous. All the legal fees are out control."[2] Washington, D.C. lawyer and tobacco-industry opponent John Coale has denounced the fee awards as "beyond human comprehension" and stated that "the work does not justify them."[3] Even the Association of American Trial Lawyers, the nation's premier representative of the plaintiffs bar, has condemned attorneys fees requested in the state tobacco settlement. The President of ATLA has noted:

> Common sense suggests that a one billion dollar fee is excessive and unreasonable and certainly should invite the scrutiny [of the courts]. [ATLA] generally refrains from expressing an institutional opinion regarding a particular fee in a particular case, but we have a strong negative reaction to reports that at least one attorney on behalf of the plaintiffs in the Florida case is seeking a fee in excess of one billion dollars.[4]

This letter, written in 1997, only concerned one of the Florida lawyers' request for attorneys fees. Ultimately, Florida's private counsel was awarded a total of $3.4 billion in fees. These statements demonstrate beyond all doubt that there is real abuse going on here, and that the victim of this abuse is the client, the plaintiff – and not the defendant.

Perhaps the best gloss on the tobacco fee awards is that provided by Professor Lester Brickman, a professor of law at Cardozo Law School and noted authority on legal ethics and attorneys fees. Professor Brickman has stated:

> Under the rules of legal ethics, promulgated partly as a justification for the legal profession's self-governance, fees cannot be 'clearly excessive.' Indeed, that standard has now been superseded in most states by an even more rigorous

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[1] Michael Ciresi, as quoted in Barry Meier, *Case Study in Tobacco Law: How a Fee Jumped in Days*, THE NEW YORK TIMES, December 15, 1998, at A16.

[2] David A. Kessler, as quoted in Barry Meier, *Case Study in Tobacco Law: How a Fee Jumped in Days*, THE NEW YORK TIMES, December 15, 1998, at A16.

[3] Robert Levy, *Hired Guns Corral Contingent Fee Bon*, LEGAL TIMES, February 1, 1999.

[4] Letter from Richard D. Hailey, President, Association of Trial Lawyers of America, to Rep. Howard Coble, R-NC (quoted in *Fla. Lawyers Attacked by Peers; Trial Association SaysFees Excessive; Smoke under Fire,* RICHMOND TIMES-DISPATCH, Wednesday, December 10, 1997, at A7.)

> standard: fees have to be 'reasonable.' Are these fees, which in many cases amount to effective hourly rates of return of tens of thousands – and even hundreds of thousands – of dollars an hour, reasonable? I think to ask the question is to answer it.[5]

The attorneys fees awarded in the state tobacco settlement are simply indefensible. And the process by which the fees were awarded partly explains how they came to be so. Outside counsel fees were determined by a private arbitration panel established by the Master Settlement Agreement (MSA) that resolved 46 of the states' litigation. (Four other states had settled their suits earlier. Their lawyers, however, also were paid out of the accounts created by the MSA.) Amazingly, the settlement agreement explicitly immunized all fee awards from judicial review. Even more amazingly, one of the three arbitrators who made the awards had a clear conflict of interests: he was the father of a South Carolina lawyer whose law firm has received the largest fee awards of all, believed to amount to over $2 billion. Another one of the arbitrators had no background in fee arbitrations or any related matter, and simply ignored the law in order to make outrageous awards, using the salaries of sports stars and entertainers as a basis of measure. The third arbitrator, a retired federal judge appointed by President Carter, dissented from the key fee decisions.

As incredible as the MSA fee awards and the arbitration procedures may seem, even more dubious is the process by which many of the law firms that participated in this lucrative litigation were selected in the first place to represent the states.

In my home state of Texas, trial lawyers have accused the then-state attorney general of demanding $1 million in campaign contributions in exchange for their being hired to represent the state in the tobacco litigation. One prominent lawyer – a former president of the Texas Trial Lawyers Association – has since said that the attorney general's solicitation was so blatant that "I knew th[at] instant . . . that I could not be involved in the matter." He even later wondered if the meeting had been a "sting operation." Another lawyer simply characterized his encounter with the attorney general as a bribery solicitation.

This former Texas attorney general was recently indicted on federal charges of attempting to fraudulently divert $260 million in tobacco-settlement legal fees to one of his personal friends. He had given a sworn affidavit that this lawyer had served as Texas's "primary adviser" in its tobacco lawsuit – despite the fact that the lawyer had attended no court hearings, depositions, or strategy meetings, wrote no memos or legal briefs about the case, and apparently never even spoke to any of the other attorneys. The attorney general even went so far as to forge and fraudulently backdate documents in order to win his friend a share of the tobacco settlement fee.

As for the five law firms that actually did represent Texas in the tobacco litigation, they filed relatively late lawsuits that were based on other lawyers' work – and yet, despite the minimal energy expended on those suits, were awarded $3.3 billion in attorneys fees. This award amounts to compensation that, even assuming that the attorneys worked all day every day during the entire period of the litigation, remains well in excess of $100,000 an hour. As one newspaper editorial has noted, for the amount of money that these lawyers were awarded, Texas could hire 10,000 additional teachers or policemen for ten years. Instead, four of these firms gave the attorney general $150,000 in campaign contributions in recent years.

Texas's experience is not an isolated example. In other states as well, lawyers' participation in

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[5] Professor Lester Brickman, *The Tobacco Litigation and Attorneys' Fees*, 67 FORDHAM L. REV. 2827, 2830 (1999).

the tobacco litigation appears to have been the product of political favoritism – and to have resulted in unfathomable fees that bear no reasonable relation to the services provided. For example:

- New Jersey: the private in-state lawyers who represented this state in the tobacco litigation have admitted that they had no mass-tort litigation experience and played no role in the state settlement talks. They have also admitted that all the key work in the state's lawsuit was done by out-of-state firms – the in-state firms' principal work was drafting pro hac vice motions to have these outside lawyers admitted in New Jersey courts. Any work that the New Jersey lawyers did was submitted to the outside lawyers, who made all of the substantive arguments. Result: these in-state lawyers were awarded $350 million in the MSA fee arbitration. Connections: the New Jersey lawyers were an inside group of past presidents of the New Jersey trial lawyers' association. The State refused to even consider hiring a nonprofit firm to conduct the New Jersey lawsuit.

- Pennsylvania: settlement talks had already begun, the states' tobacco litigation was being resolved, and all of the legal theories already had been developed long before the Pennsylvania state suit was filed. Result: Pennsylvania's private lawyers were awarded $50 million in the MSA arbitration – equivalent to 1000% of a reasonable hourly rate. As one expert has noted, "there's not $50 million of work in there." Connections: the two law firms that the state Attorney General selected to conduct the litigation were among his top campaign contributors. The firms were awarded no-bid contracts. As one Pennsylvania commentator has noted, "obviously, it was a political kind of thing."

- Maryland: billionaire tort lawyer Peter Angelos demanded a one billion dollar fee for his work on that state's case, even though, according to the state Senate President, the state legislature had retroactively "changed centuries of precedent to ensure [Angelos] a win in the case." Angelos ultimately receive an accelerated $150 million payment for this no-risk lawsuit.

- Louisiana: the private law firms that represented the state in the tobacco litigation were awarded $575 million. The MSA arbitration panel actually increased this award on the ground that the state government – the lawyers' supposed client – was opposed to suing tobacco companies. The Louisiana fee award amounts to almost $7000 an hour, based on the lawyers' estimate that they worked a total 85,000 hours. This estimate, however, is unverifiable, since the state's private lawyers kept no billing records – as the attorney general explained, "I wasn't that big on hourly or written reports." The dissenting member of the arbitration panel simply noted that the Louisiana fee award "shocks the conscience." The single biggest beneficiary of this largesse – receiving $115 million in attorneys fees – was a law firm based in Lake Charles, the hometown of the state's attorney general. This firm and the next largest fee recipient had donated over $42,000 to the attorney general's political campaigns. Together, all of the firms that represented Louisiana gave more than $100,000 to the attorney general in the years before they were selected to participate in the state's tobacco team.

- Ohio: the lawyers representing this state received fees estimated to exceed $50,000 per hour, despite the fact that, according to independent observers, "all of the legal issues were resolved long before these Ohio lawyers stepped up to the plate." The state's outside counsel had donated $26,000 in campaign contributions to the state attorney general prior to their appointment to the state's tobacco team. After the attorney general chose one private lawyer to serve as the state's "lead special counsel," that lawyer hired one of the attorney general's top aides for an undisclosed sum in order to – in the lawyer's own words – "help me get acquainted with a technique called PowerPoint." When told that "there were many people in Ohio capable of doing a PowerPoint presentation," the

state's outside counsel responded that this particular attorney general's aide "was the only one I knew of."

- Massachusetts: according to other tobacco plaintiffs' lawyers, Massachusetts's suit piggybacked on the work of other lawyers and was not pivotal to the outcome of the tobacco litigation. Result: $775 million was awarded to the Massachusetts lawyers in the MSA arbitration.

- New York: when this state's then-attorney general hired private counsel to represent the state in its tobacco lawsuit, tobacco companies already had paid $15 billion to Florida and Mississippi for identical claims and a national settlement agreement already was under discussion. As one local anti-tobacco leader has noted, "these were copycat lawsuits, there wasn't all that much work to do." The firms' primary job was to collect New York-specific data in order to calculate damages. Ultimately, the New York firms represented the state for just 13 months. And they received a fee award of $625 million. This amounts to at least $14,000 an hour, for a lawsuit that by all accounts involved no risk. The dissenting member of the arbitration panel has denounced the award as "an astronomical sum unrelated to [the attorneys'] efforts or achievements." The New York firms had contributed more than $250,000 to New York politicians and their campaign organizations in the years preceding their selection – and another $200,000 after the state settlement.

- Wisconsin: the Wisconsin lawyers' tobacco litigation work has been described as chiefly consisting of media and public relations efforts on their own behalf. Their billing records included time spent selecting office space and buying furniture. One lawyer effectively billed $3000 to the state for reading an article in a Madison newspaper. The lawyers also billed the state for limousine rides around the state, trips on private jets, and stays at luxury hotels. Result: $75 million was awarded to the Wisconsin lawyers. Based on the law firms' records of the total number of hours they devoted to the case – including work by paralegals – this fee amounts to $3000 per hour.

- Missouri: a state supreme court justice in Missouri resigned his post in order to join one of the private law firms expected to receive a portion of the MSA arbitrators' fee award. Ultimately, the firms representing the state spent just 5 months on the state's lawsuit. They received a fee award of $111 million. One state leader has described the award as "the biggest rip-off in the 180-year history of the state." The law firms receiving these fees had donated more than $500,000 to state politicians and parties in the years leading up to their selection as the state's outside counsel.

These examples are too numerous to dismiss. In state after state, the temptations created by the massive, windfall fees awarded in the Medicaid tobacco settlement corrupted not only lawyers involved, but the government as well. The fee awards poisoned everything that they touched. No one who examines these events closely – who surveys the obscene fee awards, and the political cronyism that determined who benefited – can disagree that this must never be allowed to happen again.

As a final point, I would like to address a question that has been raised with regard to remedy. Some have argued that nothing can be done to correct the excesses of the tobacco settlement fee awards – even with regard to fees that are still being or have yet to be paid. On several occasions, state judges who were called upon to approve their state's tobacco settlement have also, on their own initiative, inquired into the apparent unreasonableness of the fees awarded. In each case, both the plaintiffs lawyers – and in some cases, even state officials – have challenged the state courts' authority to act. They have argued that these courts lack jurisdiction to review a national settlement, and that excessive fees cannot be restored to the state. One state's attorney

general implicated in these events has argued that it is a "misconception" that the tobacco settlement "attorneys' fees are coming out of the public's pocket. That is not the case. They [sic] defendants have agreed to pay these fees."[6]

Because of the way that the MSA fee payments are structured, no lawyer's award comes out of any one particular, identifiable state's recovery. Instead, all of the lawyers are being paid from one of two separate accounts, each of which is funded by the tobacco companies.

It is a mistake, however, to contend that, because the MSA fee payments are made directly from defendants to plaintiffs' lawyers – without ever formally or actually passing through the plaintiffs' hands – they are immunized against ethical scrutiny or correction. It is well and long established in our law that fee awards originate as the property of the client regardless of how the fee agreements are structured. The courts have been very clear on this point. As they have stated:

- "The allowance of attorney fees in a judgment gives the attorneys no interest and ownership in the judgment to the extent of the amount of the fee allowed, but the judgment in its entirety is the property of the client. The award for fees is for the client, not the attorney."[7]

- "[A]ttorneys' fee provisions exist for the benefit of parties and not the attorneys . . . . Several jurisdictions have noted that the real party in interest with regard to fees is the client and not the attorney."[8]

- "A judgment for costs is a judgment in favor of the party, and not of his attorney, and the money represented by the costs is the property of the party."[9]

- "[T]he award of attorney fees [is] made not to the attorneys but to the litigant who was personally liable to the attorneys. This is also the view in other states when the courts award attorney fees."[10]

- "An award of attorney's fees belongs to the client and not the attorney."[11]

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[6] New York Attorney General Elliot Spitzer, as quoted in Margaret A. Little, *A Most Dangerous Indiscretion: the Legal, Economic, and Political Legacy of the Governments' Tobacco Litigation*, 33 U. CONN. L. REV. 1143, 1185 n.193 (2001).

[7] *Carmichael v. Iowa State Highway Comm'n*, 219 N.W.2d 658 (Iowa 1974) (citing 7 C.J.S. *Attorney and Client* § 163, pp. 1020-21).

[8] *Alfred J.L. v. Leo J.R.*, 1986 WL 9919, *4 (Del.Super. Sept. 4, 1986) (citing cases).

[9] *Erickson v. Foote*, 153 A. 853, 854 (Conn. Supr. 1931).

[10] *Matter of Estate of Robinson*, 690 P.2d 1383, 1388 (Kan.1984).

[11] *Carlton v. Owens*, 443 So.2d 1227, 1232 (Ala. 1983). *See also In re McRoberts' Estate*, 43 A.2d 910, 911 (Pa. Super. 1945) (counsel fees "belong, and are awarded, to the petitioner, not counsel"); *Venegas v. Mitchell*, 495 U.S. 82, 87 (1990) ("Section 1988 makes the prevailing party eligible for a discretionary award of attorney's fees. * * * it is the party, rather than the lawyer, who is so eligible") (citations omitted).

Indeed, an award of attorney fees is generally taxable as income to the client. In a recent case, the U.S. Court of Appeals for the Ninth Circuit noted that a plaintiff's obligation to compensate the law firm that represented him "was satisfied by [the defendant]. The payment was therefore to [the client]. The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed." The Ninth Circuit emphasized that the fact "[t]hat [the client] never laid hands on the money paid to the lawyers does not obliterate their constructive receipt." In other words, the fee award belongs to the client, regardless of how the award is made.

The rule that fee awards belong to the client is strongly supported by important policy considerations. It is necessary because any other rule would be an invitation to collusion and self-dealing between plaintiffs' lawyers and defendants. Again, the courts have been very clear on this point. As the Third Circuit has noted:

> [A] defendant is interested only in disposing of the total claims asserted against it, and the allocation between the [plaintiff's] payment and the attorneys' fees is of little or no interest to the defense. Moreover, the divergence in class members' and class counsel's financial incentives creates the danger that the lawyers might urge a class settlement at a low figure or on a less-than-optimal basis in exchange for red-carpet treatment for fees.[12]

The Second Circuit has made the same point, noting:

> Defendants, once the settlement amount has been agreed to, have little interest in how it is distributed and thus no incentive to oppose the [attorneys] fee. Indeed, the same dynamic creates incentives for collusion – the temptation for lawyers to agree to a less than optimal settlement in exchange for [generous fees].[13]

The Ninth Circuit has also addressed the question of "whether a class member has standing to appeal class counsel's attorney fee and cost award when that award is payable by the defendant independently, and not out of the class settlement." The court concluded that "[e]ven if class counsel's attorney fees are not to be paid from the class settlement . . . , the aggregate amount of the attorney fees and the class settlement payments may be viewed as "a constructive common fund." The court reasoned that "[i]f . . . class counsel agreed to accept excessive fees and costs to the detriment of class plaintiffs, then class counsel breached their fiduciary duty to the class. If that were the case, any excessive award could be considered property of the class plaintiffs, and any injury they suffered could be at least partially redressed by allocating to them a portion of that award."[14]

As several commentators have noted, the policy considerations underpinning the rule that fee awards belong to the client apply with full force to the state tobacco settlement. Indeed, that settlement could serve as a textbook example for why this rule exists. As Professor Brickman has noted:

> To the tobacco companies, dollars are dollars, whether paid to states or paid to lawyers. So the real amount on the bargaining table was not the $246 billion that

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[12] *In re Cendant Corp. PRIDES Litig.*, 243 F.3d 722, 728 (3d Cir. 2001).

[13] *Goldberger v Integrated Resources, Inc.*, 209 F.3d 43, 52 (2d Cir. 2000).

[14] *Lobatz v. U.S. West Cellular of California, Inc.*, 222 F.3d 1142, 1146-47 (9th Cir. 2000).

> the states settled for, but a larger sum, including the amount to be paid to the attorneys. . . . Stated simply, because dollars are fungible, the fees are coming out of the settlements.[15]

Even foreign commentators have noted that the state tobacco settlement's "arbitration is a mere figleaf. The money going to the lawyers was clearly part of the overall amount that the tobacco companies were willing to pay to settle the case. Whatever the lawyers get, the states do not."[16]

And this point has not been lost upon members of Congress. Representative Chris Cox (R-CA) has testified on the matter:

> It is specious to argue that [billions of dollars] in fees are not being diverted out of funds available for public health and taxpayers. The tobacco industry is willing to pay a certain sum to get rid of these cases. That sum is the total cost of the payment to the plaintiffs and their lawyers. It is a matter of indifference to the industry how that sum is divided – 75% for the plaintiffs and 25% for their lawyers, or vice versa. That means that every penny paid to the plaintiffs' lawyers – whether it is technically 'in' the settlement or not – is money that the industry could have paid to the state or the private plaintiffs. Excessive attorneys' fees in this case will not be a victimless crime.[17]

I hope that these authorities and their reasoning are sufficient to permanently dispel the notion that an attorney fee agreement can be structured so as to evade the ethical obligation to charge only a reasonable fee. The defenders of the MSA fee payments are simply misleading the public and this distinguished body when they assert that a particular lawyer's award under the settlement does not come out of a particular state's recovery. That fee comes out of all of the state's recoveries. All excessive or unreasonable fees should be restored to all 50 of the states.

Senator Kyl has already presented estimates of the monetary recovery each state can expect if ISCRAA is enacted. I would simply point out here that, according to those estimates, Texas has been charged excessive and unreasonable attorney fees in the amount of $667 million, and therefore would recover those funds if this legislation is adopted.

ISCRAA's return of unethical tobacco-settlement fee awards to the states is manifestly proper in light of the fact that all fee awards are the property of the client, and the attorney is entitled only to a reasonable fee. No attorney is above these rules and obligations. They cannot be waived or ignored. And in light of our experience with the state tobacco settlement fee awards, and their effect on our public officials, these ethical duties must be carried out and enforced strictly and fully.

Our federal and state courts generally do a good job of protecting consumers and enforcing the rights of all Americans. But there are problems in our courts that require attention and

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[15] Professor Lester Brickman, *The Tobacco Litigation and Attorneys' Fees*, 67 FORDHAM L. REV. 2827, 2832 (1999).

[16] *Knights in Golden Armour: Lawyers and Their Fees*, THE ECONOMIST, February 13, 1999, at 28.

[17] Testimony of Rep. Chris Cox, R-CA, U.S. House of Representatives, Subcommittee on Courts and Intellectual Property, December 10, 1997 (emphasis in original).

significant reform. Class action abuse not only threatens the integrity and the perception of rationality in our nation's courts, it strongly hinders economic and job growth. Tort reform is badly needed to rescue many industries, especially our health care industry, from abuses of our legal system. The judicial confirmation process at the federal level has become bitter, severe and destructive, posing a threat to judicial independence and the quality and efficiency of our courts. And abusive attorney fee arrangements make a mockery of our civil justice system, all while enriching a small band of unscrupulous litigators at the expense of the real victims, their clients.

To enforce the longstanding fiduciary duty of all attorneys to charge only a reasonable fee, in a class of cases that poses heightened risks of abuse and special significance to the national economy, I urge that this Senate consider expediently, and approve quickly, this important measure, the Intermediate Sanctions Compensatory Revenue Adjustment Act of 2003.

Thank you, Mr. President. I yield the floor.

RESPONSES TO LIKELY ARGUMENTS AGAINST ISCRAA

I. FREEDOM OF CONTRACT

Shouldn't lawyers have freedom of contract to set whatever fee they can persuade a client to agree to? Why are we singling out lawyers for regulation and not CEOs?

Short answer: Attorneys are fiduciaries whose fee contracts have always been subject to reasonableness requirements. Attorneys long have been acknowledged to be fiduciaries who occupy a position of trust in their dealings with their clients. One obligation that flows from this status, universally recognized in the ethics rules of all 50 States, is the attorney's obligation not charge an unreasonable or excessive fee. Courts have made very clear that attorneys are not equivalent to ordinary businessmen, who can engage in hard bargaining with their customers. Such behavior cannot be reconciled with an attorney's role as an officer of the court. The courts also have made clear that the requirement that a fee be reasonable will be read into every attorney fee contract, and will supercede terms that are inconsistent with this obligation.

Also: ISCRAA is very generous – even by CEO standards. ISCRAA's fee formula still permits lawyers fees that would make many CEOs envious. In the tobacco litigation, many of the plaintiffs' lawyers filed claims that they have worked tens of thousands of hours. ISCRAA would allow reasonable hourly rates – which run as high as $500 an hour in large cities – to be multiplied by up to 500%. This translates into attorneys fees of tens of millions of dollars. Not bad, considering that many of the tobacco settlement lawyers worked on their cases for just one or two years.

II. ACCESS TO JUSTICE

Won't ISCRAA's fee formula prevent poor plaintiffs in large cases from being able to get a lawyer? Won't lawyers refuse to take case under ISCRAA's fee formula?

Short answer: ISCRAA is more generous than existing formulas used by courts. ISCRAA is carefully designed to protect fiduciary interests while providing plaintiffs' lawyers with ample incentives to provide high-quality legal representation in large litigations. ISCRAA's fee formula is as generous as the limits set by the most liberal state courts that engage in meaningful review of attorneys fees, and is considerably more generous than the federal courts' practices in $100 million cases. Moreover, the multiplier criteria that ISCRAA employs universally are recognized as legitimate prerequisites for a contingency fee – even by trial lawyers' professional associations.

III. RETROSPECTIVE EFFECT

Isn't ISCRAA an unfairly retrospective change in the law? If these fees were legal when they were agreed to, why should we change them now?

Short answer: ISCRAA only enforces a liberal interpretation of pre-existing standards. ISCRAA does not change the *substantive* law governing attorneys fee awards. Rather, it simply enforces established, *pre-existing* fiduciary standards that already bind every attorney in every state. The MODEL RULES OF PROFESSIONAL CONDUCT, at Rule 1.5(a), contain a clear, direct

command that "*a lawyer's fee shall be reasonable.*" Similarly, the MODEL CODE OF PROFESSIONAL RESPONSIBILITY, at DR 2-106, directs that an attorney "*shall not* enter into an agreement for, charge, or *collect an illegal or clearly excessive fee.*" The Model Code further explains that an attorneys fee is "clearly excessive when, after a review of the facts, a lawyer of ordinary prudence would be left with a definite and firm conviction that the fee is in excess of a reasonable fee." Finally, as academic commentators point out, in addition to the model rules, "*all state rules of professional conduct prohibit attorneys from charging excessive fees.*"[6] (Emphasis added.)

Tobacco lawyers still get 2.5 billion dollars under ISCRAA. Additionally, ISCRAA does not apply to the first three-and-a-half years of fee payments under the tobacco settlement, it exempts the first two-and-a-half *billion* dollars that these lawyers received. No tobacco lawyer will go broke because of this bill. ISCRAA might simply be described as the one-yacht-per-lawyer rule.

IV. WHO OWNS THE FEE?

If a lawyer's fee award is unethical or excessive, wouldn't it go back to the *defendant*? Some of the tobacco lawyers argue that the money *can't* go back to the states. Wouldn't the lawyers money go back to the tobacco companies?

Short answer: Fee awards are the property of the client. The courts have made very clear that a fee award is the property of the client – and that any unethical fee must be restored to the client, regardless of how the fee award is structured. Any other rule would invite collusion between the defendants and the plaintiffs' lawyers. Courts repeatedly have recognized that defendants would be more than happy to agree to higher plaintiffs' lawyers fee awards in exchange for a lower recovery from the plaintiffs. A number of commentators have noted that this is exactly what happened in the tobacco settlement. In recognition of the legal principle that a fee award belongs to the client – and that an excessive fee must be restored to the client – ISCRAA specifically provides that excess tobacco settlement attorneys fees shall be restored to the states.

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[6]Vonde M. Smith Hitch, *Ethics and the Reasonableness of Contingency Fees: A Survey of State and Federal Law Addressing the Reasonableness of Costs as They Relate to Contingency Fee Agreements*, 29 LAND & WATER L. REV. 215, 218 n.22 (1994).

1. Shouldn't lawyers have freedom of contract to set whatever fee they can persuade a client to agree to? Why are we singling out lawyers for regulation and not CEOs?

Short answer: ***Attorneys are fiduciaries whose fee contracts have always been subject to reasonableness requirements.*** Attorneys long have been acknowledged to be fiduciaries who occupy a position of trust in their dealings with their clients. One obligation that flows from this status, universally recognized in the ethics rules of all 50 States, is the attorney's obligation not to charge an unreasonable or excessive fee. Courts have made very clear that attorneys are not equivalent to ordinary businessmen, who can engage in hard bargaining with their customers. Such behavior cannot be reconciled with an attorney's role as an officer of the court. The courts also have made clear that the requirement that a fee be reasonable will be read into every attorney fee contract, and will supercede terms that are inconsistent with this obligation.

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Legal Standards

- As one court has stated:

  "We realize that business contracts may be enforced between those in equal bargaining capacities, even though they turn out to be unfair, inequitable or harsh. However, *a fee agreement between lawyer and client is not an ordinary business contract*. The profession has both an obligation of public service and duties to clients which transcend ordinary business relationships and prohibit the lawyer from taking advantage of the client."[7]

- "[A]n attorney is only entitled to fees which are fair and just and which adequately compensate him for his services. This is true *no matter what fee is specified in the contract*, because an attorney, as a fiduciary, cannot bind his client to pay a greater compensation for his services than the attorney would have the right to demand if no contract had been made. Therefore, as a matter of public policy, *reasonableness is an implied term* in every contract for attorney's fees."[8]

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[7] *In the Matter of Swartz*, 686 P.2d 1236, 1243 (Ariz. 1984) (emphasis added).

[8] *Missouri ex rel. Chase Resorts, Inc. v. Campbell*, 913 S.W.2d 832 (Mo. App. 1996) (emphasis added). *See also* G. Hazard, ETHICS IN THE PRACTICE OF LAW 99 (1978) ("A contract for a [legal] fee is, under general principles of law, a contract between a fiduciary and his protected dependent * * * [and] it is unenforceable unless its terms are fair to the client").

I. FIDUCIARY RESTRAINTS ON ATTORNEYS FEE AGREEMENTS

[From Senator Kyl's speech introducing ISCRAA]

Another issue that I will address today is the argument – occasionally raised in opposition to proposals to limit attorneys fees – that such restrictions violate attorneys' rights to freedom of contract.

The first principle to keep in mind when questions of attorneys fees are considered is that "a fiduciary relationship exists as a matter of law between attorney and client."[9] (Illinois Supreme Court.) As one academic commentator has noted:

> "[I]t is uncontroverted today that a lawyer is a fiduciary for, and therefore has a duty to deal fairly with, the client. * * * * Lawyers are fiduciaries because retention of an attorney to exercise 'professional judgement' on the client's behalf necessarily involves reposing trust and confidence in the attorney. Exercising professional judgment requires that the lawyer advance the client's interests as the client would define them if the client were well-informed."[10]

The lawyer's status as fiduciary places limits on his dealings with his client – including with regard to his fee. "An attorney's freedom to contract with a client is subject to the constraints of ethical considerations."[11] (New Jersey Supreme Court.) "In setting fees, lawyers are fiduciaries who owe their clients greater duties than are owed under the general law of contracts."[12] (Massachusetts Appeals Court.) "As a result of lawyers' special role in the legal system, contracts between lawyer and client receive special scrutiny. * * * * While freedom of contract is the guiding principle underlying contract law, contractual freedom is muted in the lawyer-client and lawyer-lawyer contexts."[13] (Joseph M. Perillo, law professor.)

The unique status of attorney fee contracts has led courts to reject analogies between such agreements and other business or service contracts. Perhaps the fullest exposition is provided by

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[9] *Gaffney v. Harmon*, 90 N.E.2d 785, 788 (Ill. 1950). *See also* Charles Wolfram, MODERN LEGAL ETHICS § 4.1, at 146 (1986) ("the designation of 'fiduciary,' * * * surely attaches to the [lawyer-client] relationship").

[10] Lester Brickman, "Contingent Fees Without Contingencies: Hamlet Without the Prince of Denmark?," 37 U.C.L.A. L. REV. 29, 45-46 (1989).

[11] *Cohen v. Radio-Electronics Officers Union, Dist. 3*, 679 A.2d 1188, 1195-96 (N.J. 1996).

[12] *Garnick & Scudder, P.C. v. Dolinsky*, 701 N.E.2d 357, 358 (Mass. App. 1998).

[13] Joesph M. Perillo, *The Law of Lawyers' Contracts is Different*, 67 FORDHAM L. REV. 443, 445 (1998).

the Arizona Supreme Court:

> "We realize that business contracts may be enforced between those in equal bargaining capacities, even though they turn out to be unfair, inequitable or harsh. However, *a fee agreement between lawyer and client is not an ordinary business contract*. The profession has both an obligation of public service and duties to clients which transcend ordinary business relationships and prohibit the lawyer from taking advantage of the client. Thus, in fixing and collecting fees the profession must remember that it is 'a branch of the administration of justice and not a mere money getting trade.' ABA CANONS OF PROFESSIONAL ETHICS, Canon 12."[14]

The same principle has been identified by the Florida Supreme Court:

> "*There is but little analogy between the elements that control the determination of a lawyer's fee and those which determine the compensation of skilled craftsmen in other fields*. Lawyers are officers of the court. The court is an instrument of society for the administration of justice. Justice should be administered economically, efficiently, and expeditiously. The attorney's fee is, therefore, a very important factor in the administration of justice, and if it is not determined with proper relation to that fact it results in a species of social malpractice that undermines the confidence of the public in the bench and bar. It does more than that. It brings the court into disrepute and destroys its power to perform adequately the function of its creation."[15]

In order to protect the lawyer's public role and to enforce his fiduciary obligations, the courts read a reasonableness requirement into every attorney fee contract. "[T]he requirement that a fee be reasonable in amount overrides the terms of the contract, so that an 'unreasonable' fee cannot be recovered, even if agreed to by the client." G. Hazard, Jr. & W. Hodes, THE LAW OF LAWYERING 1. 5:205 *Fee Litigation and Arbitration* 120 (1998 Supp.).

As one court has stated,

> "[A]n attorney is only entitled to fees which are fair and just and which adequately compensate him for his services. This is true *no matter what fee is specified in the contract*, because an attorney, as a fiduciary, cannot bind his client to pay a greater compensation for his services than the attorney would have the right to demand if no contract had been made. Therefore, as a matter of public policy,

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[14] *In the Matter of Swartz*, 686 P.2d 1236, 1243 (Ariz. 1984) (emphasis added).

[15] *Kuhnlein v. Department of Revenue*, 662 So.2d 309, 313 (Fla. 1995) (emphasis added). *See also Gruber & Coabella, P.A. v. Erickson*, 784 A.2d 758, 760 (N.J.Sup.Ct. 2001) ("Attorneys have never had the right to enforce contractual provisions for more than a fair and reasonable fee. They are not businessmen entitled to charge what the traffic will bear").

reasonableness is an implied term in every contract for attorney's fees."[16]

Finally, when assessing whether a fee is reasonable, courts ask whether the fee is proportional to the services that were actually provided. "Fees must be reasonably proportional to the services rendered and the situation presented."[17] (Arizona Supreme Court.) "If an attorney's fee is grossly disproportionate to the services rendered and is charged to a client who lacks full information about all of the relevant circumstances, the fee is 'clearly excessive' * * * even though the client consented to such fee."[18] (West Virginia Supreme Court.)

Because attorneys are fiduciaries, they simply do not have complete freedom of contract in negotiating their fees. An attorney's dealings with his client always must reflect that the client comes to him in a position of trust – and therefore, the attorney's fee always must be reasonable. ISCRAA will help ensure that this important obligation is respected.

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[16] *Missouri ex rel. Chase Resorts, Inc. v. Campbell*, 913 S.W.2d 832 (Mo. App. 1996) (emphasis added). *See also* G. Hazard, ETHICS IN THE PRACTICE OF LAW 99 (1978) ("A contract for a [legal] fee is, under general principles of law, a contract between a fiduciary and his protected dependent * * * [and] it is unenforceable unless its terms are fair to the client"); *Trinkle v. Leeney*, 650 N.E.2d 749, 754 (Ind.Ct.App.1995) ("Under no circumstances is a lawyer entitled to more than the reasonable value of his or her services. [Moreover,] [r]easonable fees are not necessarily determined by the terms of the attorney-client contract").

[17] *In the Matter of Struthers*, 877 P.2d 789, 796 (Ariz. 1994).

[18] *Committee on Legal Ethics v. Tatterson*, 352 S.E.2d 107, 113 (W. Va. 1986).

2. Won't ISCRAA's fee formula prevent poor plaintiffs in large cases from being able to get a lawyer? Won't lawyers refuse to take case under ISCRAA's fee formula?

Short answer: ISCRAA is more generous than existing formulas used by courts. ISCRAA is carefully designed to protect fiduciary interests while providing plaintiffs' lawyers with ample incentives to provide high-quality legal representation in large litigations. ISCRAA's fee formula is as generous as the limits set by the most liberal state courts that engage in meaningful review of attorneys fees, and is considerably more generous than the federal courts' practices in $100 million cases. Moreover, the multiplier criteria that ISCRAA employs are recognized universally as legitimate prerequisites for a contingency fee – even by trial lawyers' professional associations.

- *Federal courts almost never award a multiplier greater than 300% in $100 million cases*:

  In 2001, the Third Circuit "set forth a chart of fee awards given in federal courts since 1985 in class actions in which the settlement fund exceeded $100 million and in which the percentage of recovery method was used."[19] (*Cendant Corp.*) The court identified 17 such cases. In almost every case, the Third Circuit could calculate the multiplier that was used, and "the lodestar multiplier in those cases never exceeded 2.99." And in the direct lodestar-multiplier cases that court identified, the multiplier ranged from 1.2 to 3.25.[20]

- *Example* (of excellent service provided despite applicability of lodestar formula):

  In re Sumitomo Copper Litig., 74 F. Supp. 2d 393 (S.D.N.Y. 1999). This RICO and Commodities Exchange Act case resulted in a recovery for the clients of $116 million. The attorneys reviewed millions of pages of documents located throughout the world, many of which had to be translated from Japanese. The federal district court awarded a multiplier of 250%, for a total fee of $32 million.

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[19] *In re Cendant Corp. PRIDES Litig.*, 243 F.3d 722, 737 (3d Cir. 2001).

[20] *See id.* at 737 n.22.

II. ISCRAA: PROVIDING ADEQUATE INCENTIVES TO LAWYERS TO PROVIDE HIGH-QUALITY LEGAL REPRESENTATION IN COMPLEX CASES

[From Senator Kyl's Senate speech introducing ISCRAA]

Another point that I would like to emphasize today is that ISCRAA is not an anti-plaintiffs' lawyer bill. It is not stingy toward trial attorneys. ISCRAA is carefully designed to protect fiduciary interests while providing plaintiffs' lawyers with ample incentives to provide high-quality legal representation in large litigations. ISCRAA's fee formula is as generous as the limits set by the most liberal state courts that engage in meaningful review of attorneys fees, and is considerably more generous than the federal courts' practices in $100 million cases. Moreover, the multiplier criteria that ISCRAA employs universally are recognized as legitimate prerequisites for a contingency fee – even by trial lawyers' professional associations.

Federal courts primarily rely on two systems for calculating attorneys fees in cases (such as class actions) in which they are required to set "reasonable fees:" the percentage method and the lodestar-multiplier method. The percentage method, as its name implies, calculates fees as a percentage of the total recovery. The lodestar system, by contrast, requires a court to first calculate a fee based on the number of hours that the lawyer worked multiplied by prevailing hourly rates (the "lodestar"). The court then multiplies this lodestar fee again in order to reward the attorney for the risk of nonpayment of fees that he assumed and for any exceptional services that he provided.

Over the last thirty years, courts have moved back and forth between these two systems.[21] Only a few courts make lodestar-multipliers the *exclusive* means of awarding attorneys fees. But as one academic commentator has noted, "lodestar, or hours-based methods, have been adopted in every [federal judicial] circuit."[22]

And more importantly, in large-recovery cases, there has been very little difference between lodestar and percentage systems. This is because even when courts apply a percentage to calculate fees, and as judgements become very large, courts typically also calculate a reasonable lodestar in order to determine what constitutes a reasonable percentage. Thus, again, as the Third Circuit notes, "courts have generally decreased the percentage awarded as the amount recovered increases, and $100 million seems to be the informal marker of a 'very large' settlement."[23]

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[21] *See In re Cendant Corp. PRIDES Litig.*, 243 F.3d 722 (3d Cir. 2001).

[22] Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STANFORD L. REV. 497, 538 n.160 (1991) (citing cases). *See also Goldberger v. Integrated Resources, Inc.*, 209 F.3d 43, 49 (2d Cir. 2000) (noting that in addition to Second Circuit, "six other circuits have reaffirmed that district courts enjoy the discretion to use either the lodestar or the percentage method") (citing cases).

[23] *In re Cendant Corp. PRIDES Litig.*, 243 F.3d 722, 736 n.19 (3d Cir. 2001).

Courts have been wary of awarding fees based on percentages alone. As one state supreme court explains:

> "[T]o begin the assessment by arbitrarily picking a percentage amount without any reliance on a cognizable structure invites decisions that are nonobjective and inconsistent. What constitutes a reasonable percentage may differ from one judge to another depending on each judge's predilections, background, and geographical location in the state."[24]

Thus "courts that employ the percentage approach appear to be motivated in part by a lodestar dynamic. Because courts are reluctant to give fee awards totally incommensurate with the efforts of the attorneys, percentage awards generally decrease as the amount of the recovery increases."[25]

One result of the cross-use of the lodestar and percentage systems is that even when courts use the percentage system, those awards overwhelmingly tend to reflect a reasonable lodestar multiplier. Therefore, even percentage-based cases tend to provide evidence of the range of multipliers that the courts consider to be reasonable.

In 2001, the Third Circuit "set forth a chart of fee awards given in federal courts since 1985 in class actions in which the settlement fund exceeded $100 million and in which the percentage of recovery method was used."[26] (*Cendant Corp.*) The court identified 17 such cases. In almost every case, the Third Circuit could calculate the multiplier that was used, and "the lodestar multiplier in those cases never exceeded 2.99." And in the direct lodestar-multiplier cases that the court identified, the multiplier ranged from 1.2 to 3.25.[27]

Other courts, surveying smaller cases than the $100 million recoveries examined in *Cendant Corp.*, have identified larger multipliers. One federal district court has "observe[d] that in virtually every case where the court notes a lodestar but awards fees based upon a percentage, the lodestar multiplier converted from this percentage is in the range of 1 to 4."[28] Another federal district court has found that "the range of lodestar multipliers in large and complicated class

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[24] *Kuhnlein v. Dep't of Revenue*, 662 So.2d 309, 313 (Fla. 1995).

[25] *In re Unisys Corp. Retiree Medical Benefits ERISA Litig.*, 886 F.Supp 445, 463 (E.D.Pa. 1995). *See also Goldberger v Integrated Resources, Inc.*, 209 F.3d 43, 50 (2d Cir. 2000) ("the lodestar remains useful as a baseline even if the percentage method is chosen. Indeed, we encourage the practice of requiring documentation of hours as a 'cross check' on the reasonableness of the requested percentage").

[26] *In re Cendant Corp. PRIDES Litig.*, 243 F.3d 722, 737 (3d Cir. 2001).

[27] *See id.* at 737 n.22.

[28] *In re Unisys Corp. Retiree Medical Benefits ERISA Litig.*, 886 F.Supp 445, 464 n.36 (E.D.Pa. 1995).

actions runs from a low of 2.26 to a high of 4.5."[29]

By contrast, some courts have declared that they would allow only lower multipliers. One federal court has stated that "only in the most exceptional circumstances would this court award a multiplier of 3 or greater. * * * this court believes that lodestars enhanced by multipliers less than 3 should adequately compensate even the most talented counsel."[30] And the Seventh Circuit has suggested that "it may be that a doubling of the lodestar would provide a sensible ceiling."[31]

On the other hand, the Florida Supreme Court – which is generally regarded as one of the more plaintiff-friendly courts in the United States – has announced that:

> "we set the maximum multiplier available in this common-fund category of cases at 5. * * * * [A] multiplier which increases fees to five times the accepted hourly rate is sufficient to alleviate the contingency risk factor involved and attract high level counsel to common fund cases while producing a fee that remains within the bounds of reasonableness. We emphasize that 5 is a maximum multiplier."[32]

ISCRAA adopts this more liberal standard. It allows fees as high as 500% of reasonable hourly rates. ISCRAA awards multipliers based on two criteria: it allows up to 300% to be added onto the amount of reasonable hourly fees if a case involved a substantial risk of nonrecovery of fees, and allows an additional 100% add-on if the attorney provided exceptional services that improved the plaintiff's recovery.

The criteria that ISCRAA employs are recognized universally as necessary prerequisites to the legitimacy of a contingency fee. "Courts in general have insisted that a contingent fee be truly contingent. The typically elevated fee reflecting the risk to the lawyer of receiving no fee will be permitted only if the representation indeed involves a significant degree of risk." Charles W. Wolfram, MODERN LEGAL ETHICS § 9.4, at 532 (1986). The risk requirement has been recognized ever since contingency fees first were allowed in the United States. The American Bar Association even noted at that time that "a contract for a contingent fee, where sanctioned by law, should be reasonable under all the circumstances of the case, including the risk and uncertainty of the compensation." ABA CANONS OF PROFESSIONAL ETHICS, Canon 13 (1908). Indeed, even the professional associations of plaintiffs' attorneys have, at times, acknowledged that contingent fees should be based on an actual contingency. In a guide to its members, the Association of Trial Lawyers of America has "recommend[ed]" that attorneys "exercise sound judgment in using a percentage in the contingent fee contract that is commensurate with the risk,

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[29] *Behrens v. Wometco Enterprises, Inc.*, 118 F.R.D. 534, 549 (S.D.Fla.1988).

[30] *In re Unisys Corp. Retiree Medical Benefits ERISA Litig.*, 886 F.Supp 445, 482 (E.D.Pa. 1995).

[31] *Skelton v. General Motors Corp.*, 860 F.2d 250, 258 (7th Cir. 1988).

[32] *Kuhnlein v. Dep't of Revenue*, 662 So.2d 309, 315 (Fla. 1995) (emphasis in original).

cost and effort required." ATLA, KEYS TO THE COURTHOUSE: QUICK FACTS ON THE CONTINGENCY FEE SYSTEM 13 (1994).

The criteria that ISCRAA employs are accepted universally – and the limits that it sets should be universally acceptable. ISCRAA is not intended to *alter* the considered standards of any jurisdiction. Rather, it is intended to *enforce* those standards – and to correct the occasional extreme outlier. Because ISCRAA incorporates a fee formula that is substantially more liberal than the usual practices of the federal courts in $100 million cases, we can be confident that high-quality legal representation will remain available to plaintiffs in these large litigations. *See, e.g. in re Sumitomo Copper Litig.*, 74 F. Supp. 2d 393 (S.D.N.Y. 1999) (RICO and Commodities Exchange Act case resulting in $116 million recovery; attorneys reviewed millions of pages of documents located throughout the world, many requiring translation from Japanese; federal district court awards multiplier of 250% for total fee of $32 million).

3. Isn't ISCRAA an unfairly retrospective change in the law? If these fees were legal when they were agreed to, why should we change them now?

Short answer: ISCRAA only enforces a liberal interpretation of pre-existing standards. ISCRAA does not change the *substantive* law governing attorneys fee awards. Rather, it simply enforces established, *pre-existing* fiduciary standards that already bind every attorney in every state. The MODEL RULES OF PROFESSIONAL CONDUCT, at Rule 1.5(a), contain a clear, direct command that "*a lawyer's fee shall be reasonable.*" Similarly, the MODEL CODE OF PROFESSIONAL RESPONSIBILITY, at DR 2-106, directs that an attorney "*shall not* enter into an agreement for, charge, or *collect an illegal or clearly excessive fee.*" The Model Code further explains that an attorney's fee is "clearly excessive when, after a review of the facts, a lawyer of ordinary prudence would be left with a definite and firm conviction that the fee is in excess of a reasonable fee." Finally, as academic commentators point out, in addition to the model rules, "*all state rules of professional conduct prohibit attorneys from charging excessive fees.*"[33] (Emphasis added.)

Tobacco lawyers still get 2.5 billion dollars under ISCRAA. Additionally, ISCRAA does not apply to the first three-and-a-half years of fee payments under the tobacco settlement, it exempts the first two-and-a-half *billion* dollars that these lawyers received. No tobacco lawyer will go broke because of this bill. ISCRAA might simply be described as the one-yacht-per-lawyer rule.

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[33] Vonde M. Smith Hitch, *Ethics and the Reasonableness of Contingency Fees: A Survey of State and Federal Law Addressing the Reasonableness of Costs as They Relate to Contingency Fee Agreements*, 29 LAND & WATER L. REV. 215, 218 n.22 (1994).

III. ISCRAA'S EFFECTIVE DATE AND THE TOBACCO STATE SETTLEMENT

[From Senator Kyl's speech introducing ISCRAA]

Another subject that I would like to address today is ISCRAA's effective date. ISCRAA applies to attorney fee payments received after June 1, 2002. This effective date is appropriate under the circumstances of the state tobacco settlement for several reasons: first, Congress routinely enacts major tax legislation with effective dates that look back much further than does ISCRAA. The Supreme Court has "repeatedly upheld [such moderately] retroactive tax legislation against a due process challenge." *United States v. Carlton*, 512 U.S. 26, 30-31 (1994); *see id.* at 33 (upholding tax whose "actual retroactive effect * * * extended for a period only slightly greater than one year").

Second, ISCRAA is not even truly retroactive. ISCRAA does not change the *substantive* law governing attorneys fee awards. Rather, it simply enforces established, *pre-existing* fiduciary standards that already bind every attorney in every state. The MODEL RULES OF PROFESSIONAL CONDUCT, at Rule 1.5(a), contain a clear, direct command that "a lawyer's fee shall be reasonable." Similarly, the MODEL CODE OF PROFESSIONAL RESPONSIBILITY, at DR 2-106, directs that an attorney "shall not enter into an agreement for, charge, or collect an illegal or clearly excessive fee." The Model Code further explains that an attorneys fee is "clearly excessive when, after a review of the facts, a lawyer of ordinary prudence would be left with a definite and firm conviction that the fee is in excess of a reasonable fee." Finally, as academic commentators point out, in addition to the model rules, "*all state rules of professional conduct* prohibit attorneys from charging excessive fees."[34] (Emphasis added.)

As I described earlier, to enforce fiduciary standards, ISCRAA codifies and applies a very generous version of the fee multiplier system, allowing attorneys fees as high as 500% of reasonable hourly rates. This is considerably more generous than what federal courts typically allow in large-judgment cases. No attorney can be heard to complain that he is subjected to a law that is more generous than his existing fiduciary obligations.

Further, none of the tobacco-settlement attorneys can reasonably maintain that they have a vested right to see their fiduciary duties to the states go unenforced. Nevertheless, in order to be fair to all parties, ISCRAA's excise taxes are applied only to fees that were paid after June 1, 2002. By this date, all of the tobacco lawyers *twice* had received notice from George W. Bush that he intended to enact legislation to enforce their fiduciary obligations. In February 2000, then-candidate Bush promised that he would "extend the 'excess benefits' provision of the tax code to private lawyers who contract with states and municipalities," with "the reasonableness of the fees * * * [to] be determined by the standard judicial 'lodestar' method." And as early as February 2001, the current Administration announced that it anticipated providing "additional public health resources for the States from the President's proposal to extend fiduciary responsibilities

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[34] Vonde M. Smith Hitch, *Ethics and the Reasonableness of Contingency Fees: A Survey of State and Federal Law Addressing the Reasonableness of Costs as They Relate to Contingency Fee Agreements*, 29 LAND & WATER L. REV. 215, 218 n.22 (1994).

responsibilities to the representatives of States in tobacco lawsuits." *See* A BLUEPRINT FOR NEW BEGINNINGS: A RESPONSIBLE BUDGET FOR AMERICA'S PRIORITIES 80, Office of Management and Budget, February 28, 2001.

Under ISCRAA, all of the attorneys who participated in the state tobacco settlement still will be very liberally compensated. Because ISCRAA does not apply to the first three-and-a-half years of fee payments under the settlement, it exempts the first two-and-a-half *billion* dollars that these lawyers received. Every one of the tobacco lawyers will have more than enough money left to pay for the yachts, luxury cars, and vacation homes that were purchased with the tobacco proceeds. ISCRAA might simply be described as the one-yacht-per-lawyer rule.

4. If a lawyer's fee award is unethical or excessive, wouldn't it go back to the *defendant*? Some of the tobacco lawyers argue that the money *can't* go back to the states. Wouldn't the lawyers money go back to the tobacco companies?

Short answer*: *Fee awards are the property of the client. The courts have made very clear that a fee award is the property of the client – and that any unethical fee must be restored to the client, regardless of how the fee award is structured. Any other rule would invite collusion between the defendants and the plaintiffs' lawyers. Courts repeatedly have recognized that defendants would be more than happy to agree to higher plaintiffs' lawyers fee awards in exchange for a lower recovery from the plaintiffs. A number of commentators have noted that this is exactly what happened in the tobacco settlement. In recognition of the legal principle that a fee award belongs to the client – and that an excessive fee must be restored to the client – ISCRAA specifically provides that excess tobacco settlement attorneys fees shall be restored to the states.

According to the courts and legal-ethics experts:

- "The allowance of attorney fees in a judgment gives the attorneys no interest and ownership in the judgment to the extent of the amount of the fee allowed, but the judgment in its entirety is the property of the client. The award for fees is for the client, not the attorney."[35]

- "[A] defendant is interested only in disposing of the total claims asserted against it, and the allocation between the [plaintiff's] payment and the attorneys' fees is of little or no interest to the defense. Moreover, the divergence in class members' and class counsel's financial incentives creates the danger that the lawyers might urge a class settlement at a low figure or on a less-than-optimal basis in exchange for red-carpet treatment for fees."[36]

- "To the tobacco companies, dollars are dollars, whether paid to states or paid to lawyers. So the real amount on the bargaining table was not the $246 billion that the states settled for, but a larger sum, including the amount to be paid to the attorneys. * * * * Stated simply, because dollars are fungible, the fees are coming out of the settlements."[37]

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[35] *Carmichael v. Iowa State Highway Comm'n*, 219 N.W.2d 658 (Iowa 1974) (citing 7 C.J.S. *Attorney and Client* § 163, pp. 1020-21).

[36] *In re Cendant Corp. PRIDES Litig.*, 243 F.3d 722, 728 (3d Cir. 2001).

[37] Professor Lester Brickman, *The Tobacco Litigation and Attorneys' Fees*, 67 FORDHAM L. REV. 2827, 2832 (1999).

IV. FEE AWARDS ARE THE PROPERTY OF THE CLIENT – AND THE TOBACCO FEES BELONG TO THE STATES

[From Senator Cornyn's speech introducing ISCRAA]

As a final point, I would like to address a question that has been raised with regard to remedy. Some have argued that nothing can be done to correct the excesses of the tobacco settlement fee awards – even with regard to fees that are still being or have yet to paid. On several occasions, state judges who were called upon to approve their state's tobacco settlement have also, on their own initiative, inquired into the apparent unreasonableness of the fees awarded. In each case, both the plaintiffs' lawyers – and in some cases, even state officials – have challenged the state courts' authority to act. They have argued that these courts lack jurisdiction to review a national settlement, and that excessive fees cannot be restored to the state. One state's attorney general implicated in these events has argued that it is a "misconception" that the tobacco settlement "attorneys' fees are coming out of the public's pocket. That is not the case. They [sic] defendants have agreed to pay these fees."[38]

Because of the way that the MSA fee payments are structured, no lawyer's award comes out of any one particular, identifiable state's recovery. Instead, all of the lawyers are being paid from one of two separate accounts, each of which is funded by the tobacco companies.

It is a mistake, however, to contend that, because the MSA fee payments are made directly from defendants to plaintiffs' lawyers – without ever formally or actually passing through the plaintiffs' hands – they are immunized against ethical scrutiny or correction. It is well and long established in our law that fee awards originate as the property of the client regardless of how the fee agreements are structured. The courts have been very clear on this point. As they have stated:

- "The allowance of attorney fees in a judgment gives the attorneys no interest and ownership in the judgment to the extent of the amount of the fee allowed, but the judgment in its entirety is the property of the client. The award for fees is for the client, not the attorney."[39]

- "[A]ttorneys' fee provisions exist for the benefit of parties and not the attorneys * * * * Several jurisdictions have noted that the real party in interest with regard to fees is the client and not the attorney."[40]

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[38]New York Attorney General Elliot Spitzer, as quoted in Margaret A. Little, *A Most Dangerous Indiscretion: the Legal, Economic, and Political Legacy of the Governments' Tobacco Litigation*, 33 U. CONN. L. REV. 1143, 1185 n.193 (2001).

[39]*Carmichael v. Iowa State Highway Comm'n*, 219 N.W.2d 658 (Iowa 1974) (citing 7 C.J.S. *Attorney and Client* § 163, pp. 1020-21).

[40]*Alfred J.L. v. Leo J.R.*, 1986 WL 9919, *4 (Del.Super. Sept. 4, 1986) (citing cases).

- "A judgment for costs is a judgment in favor of the party, and not of his attorney, and the money represented by the costs is the property of the party."[41]

- "[T]he award of attorney fees [is] made not to the attorneys but to the litigant who was personally liable to the attorneys. This is also the view in other states when the courts award attorney fees."[42]

- "An award of attorney's fees belongs to the client and not the attorney."[43]

Indeed, courts even have held that an award of attorneys fees is taxable as income to the client, not to the attorney. In a recent case, the U.S. Court of Appeals for the Ninth Circuit noted that a plaintiff's obligation to compensate the law firm that represented him "was satisfied by [the defendant]. The payment was therefore to [the client]. The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed." The Ninth Circuit emphasized that the fact "[t]hat [the client] never laid hands on the money paid to the lawyers does not obliterate their constructive receipt." In other words, the fee award belongs to the client, regardless of how the award is made. And it is the client, therefore, who is "liable for the deficiency" in federal income-tax payments.

The rule that fee awards belongto the client is supported by important policy considerations. It is necessary because any other rule would be an invitation to collusion and self-dealing between plaintiffs' lawyers and defendants. Again, the courts have been very clear on this point. As the Third Circuit has noted:

> "[A] defendant is interested only in disposing of the total claims asserted against it, and the allocation between the [plaintiff's] payment and the attorneys' fees is of little or no interest to the defense. Moreover, the divergence in class members' and class counsel's financial incentives creates the danger that the lawyers might urge a class settlement at a low figure or on a less-than-optimal basis in exchange for red-carpet treatment for fees."[44]

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[41] *Erickson v. Foote*, 153 A. 853, 854 (Conn. Supr. 1931).

[42] *Matter of Estate of Robinson*, 690 P.2d 1383, 1388 (Kan.1984).

[43] *Carlton v. Owens*, 443 So.2d 1227, 1232 (Ala. 1983). *See also In re McRoberts' Estate*, 43 A.2d 910, 911 (Pa. Super. 1945) (counsel fees "belong, and are awarded, to the petitioner, not counsel"); *Venegas v. Mitchell*, 495 U.S. 82, 87 (1990) ("Section 1988 makes the prevailing party eligible for a discretionary award of attorney's fees. * * * it is the party, rather than the lawyer, who is so eligible") (citations omitted).

[44] *In re Cendant Corp. PRIDES Litig.*, 243 F.3d 722, 728 (3d Cir. 2001).

The Second Circuit has made the same point, noting that:

> "Defendants, once the settlement amount has been agreed to, have little interest in how it is distributed and thus no incentive to oppose the [attorneys] fee. Indeed, the same dynamic creates incentives for collusion – the temptation for lawyers to agree to a less than optimal settlement in exchange for [generous fees]."[45]

The Ninth Circuit has also addressed the question of "whether a class member has standing to appeal class counsel's attorney fee and cost award when that award is payable by the defendant independently, and not out of the class settlement." The court concluded that "[e]ven if class counsel's attorney fees are not to be paid from the class settlement * * * , the aggregate amount of the attorney fees and the class settlement payments may be viewed as "a constructive common fund." The court reasoned that "[i]f * * * class counsel agreed to accept excessive fees and costs to the detriment of class plaintiffs, then class counsel breached their fiduciary duty to the class. If that were the case, any excessive award could be considered property of the class plaintiffs, and any injury they suffered could be at least partially redressed by allocating to them a portion of that award."[46]

Finally, as several commentators have noted, the policy considerations underpinning the rule that fee awards belong to the client apply with full force to the state tobacco settlement. Indeed, that settlement could serve as a textbook example for why this rule exists. As Professor Brickman has noted:

> "To the tobacco companies, dollars are dollars, whether paid to states or paid to lawyers. So the real amount on the bargaining table was not the $246 billion that the states settled for, but a larger sum, including the amount to be paid to the attorneys. * * * * Stated simply, because dollars are fungible, the fees are coming out of the settlements."[47]

Even foreign commentators have noted that the state tobacco settlement's "arbitration is a mere figleaf. The money going to the lawyers was clearly part of the overall amount that the tobacco companies were willing to pay to settle the case. Whatever the lawyers get, the states do not."[48]

And this point has not been lost upon members of Congress. Representative Chris Cox (R-CA)

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[45] *Goldberger v Integrated Resources, Inc.*, 209 F.3d 43, 52 (2d Cir. 2000).

[46] *Lobatz v. U.S. West Cellular of California, Inc.*, 222 F.3d 1142, 1146-47 (9th Cir. 2000).

[47] Professor Lester Brickman, *The Tobacco Litigation and Attorneys' Fees*, 67 FORDHAM L. REV. 2827, 2832 (1999).

[48] *Knights in Golden Armour: Lawyers and Their Fees*, THE ECONOMIST, February 13, 1999, at 28.

has testified on the matter:

> "It is specious to argue that [billions of dollars] in fees are not being diverted out of funds available for public health and taxpayers. The tobacco industry is willing to pay a certain sum to get rid of these cases. That sum is the total cost of the payment to the plaintiffs *and their lawyers*. It is a matter of indifference to the industry how that sum is divided – 75% for the plaintiffs and 25% for their lawyers, or vice versa. That means that every penny paid to the plaintiffs' lawyers – whether it is technically 'in' the settlement or not – is money that the industry could have paid to the state or the private plaintiffs. Excessive attorneys' fees in this case will not be a victimless crime."[49]

I hope that these authorities and their reasoning are sufficient to permanently dispel the notion that an attorney fee agreement can be structured so as to evade the ethical obligation to charge only a reasonable fee. The defenders of the MSA fee payments are simply misleading the public and this distinguished body when they assert that a particular lawyer's award under the settlement does not come out of a particular state's recovery. That fee comes out of all of the state's recoveries. All excessive or unreasonable fees should be restored to all 50 of the states.

Senator Kyl has already presented estimates of the monetary recovery each state can expect if ISCRAA is enacted. I would simply point out here that, according to those estimates, Texas has been charged excessive and unreasonable attorney fees in the amount of $667 million, and therefore would recover those funds if this legislation is adopted.

ISCRAA's return of unethical tobacco-settlement fee awards to the states is manifestly proper in light of the fact that all fee awards are the property of the client, and the attorney is entitled only to a reasonable fee. No attorney is above these rules and obligations. They cannot be waived or ignored. And in light of our experience with the state tobacco settlement fee awards, and their effect on our public officials, these ethical duties must be carried out and enforced strictly and fully.

Our federal and state courts generally do a good job of protecting consumers and enforcing the rights of all Americans. But there are problems in our courts that require attention and significant reform. Class action abuse not only threatens the integrity and the perception of rationality in our nation's courts, it strongly hinders economic and job growth. Tort reform is badly needed to rescue many industries, especially our health care industry, from abuses of our legal system. The judicial confirmation process at the federal level has become bitter, severe and destructive, posing a threat to judicial independence and the quality and efficiency of our courts. And abusive attorney fee arrangements make a mockery of our civil justice system, all while enriching a small band of unscrupulous litigators at the expense of the real victims, their clients.

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[49]Testimony of Rep. Chris Cox, R-CA, U.S. House of Representatives, Subcommittee on Courts and Intellectual Property, December 10, 1997 (emphasis in original).

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Citation: **512 U.S. 26,AT 30**

*512 U.S. 26, *; 114 S. Ct. 2018, **;*
*129 L. Ed. 2d 22, ***; 1994 U.S. LEXIS 4449*

UNITED STATES, PETITIONER v. JERRY W. CARLTON

No. 92-1941

SUPREME COURT OF THE UNITED STATES

512 U.S. 26; 114 S. Ct. 2018; 129 L. Ed. 2d 22; 1994 U.S. LEXIS 4449; 62 U.S.L.W. 4472; 94-1 U.S. Tax Cas. (CCH) P60,169; 73 A.F.T.R.2d (RIA) 2198; 94 Cal. Daily Op. Service 4368; 94 Daily Journal DAR 8064; 18 E.B.C. 1161; 8 Fla. L. Weekly Fed. S 246

February 28, 1994, Argued
June 13, 1994, Decided

PRIOR HISTORY: ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT.

DISPOSITION: 972 F.2d 1051, reversed.

CASE SUMMARY

PROCEDURAL POSTURE: Respondent executor instituted a suit to recover the portion of the estate taxes paid after petitioner United States disallowed a deduction claimed under 26 U.S.C.S. § 2057. The United States Court of Appeals for the Ninth Circuit allowed the deduction, holding that an amendment to § 2057 could not be retroactively applied against the executor. The United States appealed.

OVERVIEW: The executor filed the estate tax return and claimed a deduction under § 2057 for half the proceeds of the sale of employer securities that he sold on behalf of the estate to an employee stock ownership plan. The United States disallowed the deduction, relying on the retroactive application of an amendment to § 2057 that allowed the deduction only if the decedent owned the stock in question immediately before dying. The executor argued that retroactive application of the amendment violated the Due Process Clause of the Fifth Amendment. The United States argued that the amendment was enacted to correct a loop hole in the statute and that retroactive application was proper. The court concluded that (1) retroactive application met the requirements of due process; (2) the purpose in enacting the amendment was neither illegitimate nor arbitrary; (3) congress acted promptly and established only a modest period of retroactivity; (4) the executor's reliance on § 2057 did not establish a constitutional violation; and (5) the executor's lack of notice did not render retroactive application unconstitutional.

OUTCOME: The court reversed the judgment of the appellate court and held that the statutory amendment retroactively applied to prohibit the executor from claiming the requested estate tax deduction; therefore, the executor was not entitled to an estate tax refund.

CORE TERMS: retroactive, stock, retroactive application, retroactively, legislative purpose, retroactivity, oppressive, decedent, harsh, rationally, executor, qualify, notice, taxation, estate tax, preceding, revision, retroactive effect, retroactive tax, new tax, exacting,

enacting, unduly, engaging, Fifth Amendment, estate tax return, unanticipated, tax-motivated, preamendment, furthered

LexisNexis(TM) HEADNOTES - Core Concepts - ♦ Hide Concepts

Estate, Gift & Trust Law > Income Taxation of Trusts & Estates
Tax Law > Federal Taxpayer Groups > Income Taxation of Estates, Trusts & Beneficiaries > Deductions & Credits (IRC secs. 641-668, 671, 681, 685)

HN1 26 U.S.C.S. § 2057 (repealed) grants a deduction for half the proceeds of any sale of employer securities by the executor of an estate to an employee stock ownership plan. § 2057(b). In order to qualify for the deduction, the sale of securities had to be made before the date on which the estate tax return was required to be filed (including any extensions). § 2057(c)(1).

Estate, Gift & Trust Law > Income Taxation of Trusts & Estates
Tax Law > Federal Taxpayer Groups > Income Taxation of Estates, Trusts & Beneficiaries > Deductions & Credits (IRC secs. 641-668, 671, 681, 685)

HN2 As amended, 26 U.S.C.S. §2057 (repealed) provides that, to qualify for the estate tax deduction, the securities sold to an employee stock ownership plan must have been "directly owned" by the decedent immediately before death. Omnibus Budget Reconciliation Act of 1987, § 10411(a). The 1987 amendment was made effective as if it had been contained in the statute as originally enacted in October 1986. § 10411(b).

Governments > Legislation > Effect & Operation > Prospective & Retrospective Operation
Constitutional Law > Substantive Due Process > Scope of Protection

HN3 The court repeatedly has upheld retroactive tax legislation against a Due Process challenge.

Constitutional Law > Substantive Due Process > Scope of Protection

HN4 The due process standard to be applied to tax statutes with retroactive effect is the same as that generally applicable to retroactive economic legislation. Provided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches. To be sure, retroactive legislation does have to meet a burden not faced by legislation that has only future effects. The retroactive aspects of legislation, as well as the prospective aspects, must meet the test of due process, and the justifications for the latter may not suffice for the former. But that burden is met simply by showing that the retroactive application of the legislation is itself justified by a rational legislative purpose.

Constitutional Law > Substantive Due Process > Scope of Protection

HN5 Tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code. Taxation is neither a penalty imposed on the taxpayer nor a liability which he assumes by contract. It is but a way of apportioning the cost of government among those who in some measure are privileged to enjoy its benefits and must bear its burdens. Since no citizen enjoys immunity from that burden, its retroactive imposition does not necessarily infringe Due Process.

Estate, Gift & Trust Law > Income Taxation of Trusts & Estates
Tax Law > Federal Taxpayer Groups > Income Taxation of Estates, Trusts & Beneficiaries > Deductions & Credits (IRC secs. 641-668, 671, 681, 685)
Governments > Legislation > Effect & Operation > Prospective & Retrospective Operation

Constitutional Law > Substantive Due Process > Scope of Protection

HN6 Retroactive application of 26 U.S.C.S. § 2057 (1987) (repealed) is rationally related to a legitimate legislative purpose, the court concludes that the amendment is consistent with the Due Process clause.

◆ Hide Lawyers' Edition Display

DECISION: Statutory amendment's retroactive application to deny federal estate tax deduction based on stock sale to employee stock ownership plan held not to violate due process.

SUMMARY: An Internal Revenue Code estate tax provision (26 USCS 2057) (later repealed), granting a deduction for half the proceeds of any sale of employer securities by the executor of an estate to an employee stock ownership plan (ESOP), went into effect in October 1986. In December 1986, in order to take advantage of the provision, the executor of the estate of an individual who had died in 1985 used estate funds to purchase corporate stock and sold the stock, at a loss of $ 631,000, to the corporate ESOP. Based on the Code provision, the executor claimed on the estate tax return a deduction for half the sale price, which reduced the tax by $ 2,501,161. In January 1987, the Internal Revenue Service (IRS) announced that, pending clarifying legislation, the IRS would treat deductions under the Code provision as available to only estates of decedents who owned the securities in question immediately before death, and in February 1987, a bill to enact an amendment to the Code provision calling for such treatment was introduced in each chamber of Congress. In December 1987, an amendment providing that, to qualify for the deduction, the securities sold to an ESOP must have been directly owned by the decedent immediately before death was enacted. The amendment was made effective as if it had been contained in the Code provision as originally enacted in October 1986. After the IRS, based on the statutory amendment, disallowed the deduction claimed on the tax return in question, the executor paid the asserted tax deficiency, and instituted a refund action based on the argument that retroactive application of the 1987 amendment to the estate's 1986 transaction violated the due process clause of the Federal Constitution's Fifth Amendment. The United States District Court for the Central District of California entered a summary judgment in favor of the United States. The United States Court of Appeals for the Ninth Circuit, expressing the view that retroactive application of the amendment in this case was unduly harsh and oppressive and therefore unconstitutional, reversed the District Court's judgment (972 F2d 1051).

On certiorari, the United States Supreme Court reversed. In an opinion by Blackmun, J., joined by Rehnquist, Ch. J., and Stevens, Kennedy, Souter, and Ginsburg, JJ., it was held that retroactive application of the amendment to the executor's 1986 transactions was consistent with the Fifth Amendment's due process clause, because (1) Congress' purpose, in enacting the amendment, of avoiding a significant and unanticipated federal revenue loss as a result of the provision's original enactment was neither illegitimate nor arbitrary, (2) Congress acted promptly and established only a modest period of retroactivity, (3) the executor's reliance on the preamended version of the provision in engaging in the stock transactions was alone insufficient to establish a constitutional violation, and (4) the executor's lack of notice regarding the amendment was not dispositive.

O'Connor, J., concurring in the judgment, expressed the view that (1) it was appropriate for the executor to make a purely tax-motivated stock transfer, and (2) a period of retroactivity longer than the year preceding the legislative session in which a retroactive tax law was enacted would raise serious constitutional questions.

Scalia, J., joined by Thomas, J., concurring in the judgment, expressed the view that the Fifth Amendment's due process clause does not prevent retroactive taxes, because the clause guarantees only process, not substantive rights.

LEXIS HEADNOTES - Classified to U.S. Digest Lawyers' Edition:

[*HN1]**
CONSTITUTIONAL LAW §617.5
estate tax deduction -- retroactive statutory amendment -- due process --

Headnote: [1A] [1B] [1C] [1D]
With respect to an Internal Revenue Code estate tax provision (26 USCS 2057) (later repealed) that became effective in October 1986 and granted a deduction for half the proceeds of any sale of employer securities by the executor of an estate to an employee stock ownership plan (ESOP), retroactive application of the provision's amendment--which is (1) enacted in December 1987, (2) made effective as if the amendment was contained in the provision as originally enacted in October 1986, and (3) provides that, to qualify for the deduction, the securities sold to an ESOP must have been directly owned by the decedent immediately before death--to deny, on the federal estate tax return of an individual who died in 1985, a deduction based on the executor's December 1986 sale, at a loss, to a corporate ESOP of corporate stock purchased with estate funds in December 1986 is consistent with the due process clause of the Federal Constitution's Fifth Amendment, because (1) Congress' purpose in enacting the amendment was neither illegitimate nor arbitrary, since there is no plausible contention that Congress, which acted to correct what Congress reasonably viewed as a mistake in the original 1986 provision that would have created a significant and unanticipated federal revenue loss, acted with an improper motive; (2) Congress acted promptly and established only a modest period of retroactivity, since (a) the actual retroactive effective of the amendment extended for a period only slightly greater than 1 year, and (b) the amendment was proposed by the Internal Revenue Service in January 1987 and by Congress in February 1987, within a few months of the provision's original enactment; (3) the executor's reliance on the preamended version of the provision in engaging in the stock transactions is alone insufficient to establish a constitutional violation, since (a) tax legislation is not a promise, and (b) a taxpayer has no vested right in the Internal Revenue Code; and (4) the executor's lack of notice regarding the amendment is not dispositive, since prior United States Supreme Court cases have not required advance notice of retroactive tax laws. (Scalia and Thomas, JJ., dissented in part from this holding.)

[*HN2]**
CONSTITUTIONAL LAW §89.5
tax legislation -- economic legislation -- retroactive application -- due process --

Headnote: [2]
Under the Federal Constitution, the due process standard to be applied to tax statutes that have retroactive effect is the same standard that is generally applicable to retroactive economic legislation--under which standard (1) provided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches, and (2) although retroactive legislation must meet a burden not faced by legislation that has only future effects, in that the due process justifications for prospective legislation may not suffice for retroactive legislation, the burden is met simply by showing that the retroactive application of the legislation itself is justified by a rational legislative purpose--because the "harsh and oppressive" formulation stated in some prior United States Supreme Court decisions concerning retroactive tax provisions does not differ from the prohibition against arbitrary and irrational legislation that applies generally to enactments in the sphere of economic policy.

[*HN3]**
CONSTITUTIONAL LAW §513
due process -- detrimental reliance --

Headnote: [3]
Although an entirely prospective change in the law may disturb the relied-upon expectations of individuals, such a change would not be deemed therefore to be violative of due process, under the Federal Constitution.

SYLLABUS:

As adopted in October 1986, 26 U.S.C. § 2057 granted an estate tax deduction for half the proceeds of "any sale of employer securities by the executor of an estate" to "an employee stock ownership plan" (ESOP). In December 1986, respondent Carlton, acting as an executor, purchased shares in a corporation, sold them to that company's ESOP at a loss, and claimed a large § 2057 deduction on his estate tax return. In December 1987, § 2057 was amended to provide that, to qualify for the deduction, the securities sold to an ESOP must have been "directly owned" by the decedent "immediately before death." Because the amendment applied retroactively, as if it were incorporated in the original 1986 provision, the Internal Revenue Service (IRS) disallowed Carlton's § 2057 deduction. The District Court entered summary judgment against him in his ensuing refund action, rejecting his contention that the amendment's retroactive application to his transactions violated the Due Process Clause of the Fifth Amendment. The Court of Appeals reversed, holding that such application was rendered unduly harsh and oppressive, and therefore unconstitutional, by Carlton's lack of notice that § 2057 would be retroactively amended and by his reasonable reliance to his detriment on preamendment law.

Held: The 1987 amendment's retroactive application to Carlton's 1986 transactions does not violate due process. Under the applicable standard, a tax statute's retroactive application must be supported by a legitimate legislative purpose furthered by rational means. See, *e. g., Pension Benefit Guaranty Corporation* v. *R. A. Gray & Co.*, 467 U.S. 717, 729-730, 81 L. Ed. 2d 601, 104 S. Ct. 2709. Here, Congress' purpose in enacting the 1987 amendment was neither illegitimate nor arbitrary. Section 2057 was originally intended to create an incentive for stockholders to sell their companies to their employees, but the absence of a decedent-stock-ownership requirement resulted in the deduction's broad availability to virtually any estate, at an estimated loss to the Government of up to $ 7 billion in anticipated revenues. Thus, Congress undoubtedly intended the amendment to correct what it reasonably viewed as a mistake in the original provision. There is no plausible contention that it acted with an improper motive, and its decision to prevent the unanticipated revenue loss by denying the deduction to those who made purely tax-motivated stock transfers was not unreasonable. Moreover, the amendment's retroactive application is rationally related to its legitimate purpose, since Congress acted promptly in proposing the amendment within a few months of § 2057's original enactment and established a modest retroactivity period that extended only slightly longer than one year. The Court of Appeals' exclusive focus on the taxpayer's notice and reliance held § 2057 to an unduly strict standard. Pp. 30-35.

COUNSEL: Kent L. Jones argued the cause for the United States. With him on the brief were Solicitor General Days, Acting Assistant Attorney General Paup, Deputy Solicitor General Wallace, Gilbert S. Rothenberg, and Teresa E. McLaughlin.

Russell G. Allen argued the cause and filed a brief for respondent. With him on the brief was Phillip R. Kaplan. *

* Briefs of amici curiae urging affirmance were filed for the Washington Legal Foundation et al. by Joseph E. Schmitz, Charles A. Shanor, Daniel J. Popeo, and Paul D. Kamenar; and for Anthony C. Morici, Jr., Executor and Trustee of the estate of McNamee, by Charles C. Marson.

JUDGES: BLACKMUN, J., delivered the opinion of the Court, in which REHNQUIST, C. J., and

STEVENS, KENNEDY, SOUTER, and GINSBURG, JJ., joined. O'CONNOR, J., filed an opinion concurring in the judgment, post, p. 35. SCALIA, J., filed an opinion concurring in the judgment, in which THOMAS, J., joined, post, p. 39.

OPINIONBY: BLACKMUN

OPINION: [*27] [*26] [**2020]** JUSTICE BLACKMUN delivered the opinion of the Court.

In 1987, Congress amended a provision of the federal estate tax statute by limiting the availability of a recently added deduction for the proceeds of sales of stock to employee stock-ownership plans (ESOP's). Congress provided that the amendment would apply retroactively, as if incorporated in the original deduction provision, which had been adopted in October 1986. The question presented by this case is whether the retroactive application of the amendment violates the Due Process Clause of the Fifth Amendment.

[*28] I

Congress effected major revisions of the Internal Revenue Code in the Tax Reform Act of 1986, 100 Stat. 2085. One of those revisions was the addition of a new estate tax provision applicable to any estate that filed a timely return after the date of the Act, October 22, 1986. The new provision, codified as HN1 26 U.S.C. § 2057 (1982 ed., Supp. IV), n1 granted a deduction for half the proceeds of "any sale of employer securities by the executor of an estate" to "an employee stock ownership plan." § 2057(b). n2 In order to qualify for the deduction, the sale of securities had to be made "before the **[***27]** date on which the [estate **[**2021]** tax] return . . . [was] required to be filed (including any extensions)." § 2057(c)(1).

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n1 Section 2057 was repealed for estates of decedents who died after December 19, 1989. See Omnibus Budget Reconciliation Act of 1989, § 7304(a), 103 Stat. 2352.

n2 Section 2057(e) defined "employer securities" by reference to § 409(*l*) of the Code, which in turn defined the term generally as "common stock issued by the employer (or by a corporation which is a member of the same controlled group) which is readily tradable on an established securities market." 26 U.S.C. § 409(*l*)(1) (1982 ed., Supp. IV).

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Respondent Jerry W. Carlton, the executor of the will of Willametta K. Day, deceased, sought to utilize the § 2057 deduction. Day died on September 29, 1985. Her estate tax return was due December 29, 1986 (after Carlton had obtained a 6-month filing extension). On December 10, 1986, Carlton used estate funds to purchase 1.5 million shares of MCI Communications Corporation for $ 11,206,000, at an average price of $ 7.47 per share. Two days later, Carlton sold the MCI stock to the MCI ESOP for $ 10,575,000, at an average price of $ 7.05 per share. The total sale price thus was $ 631,000 less than the purchase price. When Carlton filed the estate tax return on December 29, 1986, he claimed a deduction under § 2057 of $ 5,287,000, for half the proceeds of the sale of the stock to the MCI ESOP. The deduction reduced the estate tax by $ 2,501,161. The parties have stipulated **[*29]** that Carlton engaged in the MCI stock transactions specifically to take advantage of the § 2057 deduction.

On January 5, 1987, the Internal Revenue Service (IRS) announced that, "pending the enactment of clarifying legislation," it would treat the § 2057 deduction as available only to estates of decedents who owned the securities in question immediately before death. See

IRS Notice 87-13, 1987-1 Cum. Bull. 432, 442. A bill to enact such an amendment to § 2057 was introduced in each Chamber of Congress on February 26, 1987. See 133 Cong. Rec. 4145 and 4293 (1987).

On December 22, 1987, the amendment to § 2057 was enacted. HN2 As amended, the statute provided that, to qualify for the estate tax deduction, the securities sold to an ESOP must have been "directly owned" by the decedent "immediately before death." Omnibus Budget Reconciliation Act of 1987, § 10411(a), 101 Stat. 1330-432. n3 The 1987 amendment was made effective as if it had been contained in the statute as originally enacted in October 1986. § 10411(b).

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n3 The amendment also required that employer securities qualifying for the deduction must, after the sale, be allocated to participants or held for future allocation in accordance with certain rules.

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The IRS disallowed the deduction claimed by Carlton under § 2057 on the ground that the MCI stock had not been owned by his decedent "immediately before death." Carlton paid the asserted estate tax deficiency, plus interest, filed a claim for refund, and instituted a refund action in the United States District Court for the Central District of California. He conceded that the estate did not qualify for the deduction under the 1987 amendment to § 2057. He argued, however, that retroactive application of the 1987 amendment to the estate's 1986 transactions violated the Due Process Clause of the Fifth Amendment. The District Court rejected his argument and entered summary judgment in favor of the United States.

A divided panel of the Court of Appeals for the Ninth Circuit reversed. 972 F.2d 1051 (1992). The majority considered [*30] two factors paramount in determining whether retroactive application of a tax violates **[***28]** due process: whether the taxpayer had actual or constructive notice that the tax statute would be retroactively amended, and whether the taxpayer reasonably relied to his detriment on preamendment law. The court concluded that both factors rendered retroactive application of the amendment in this case unduly harsh and oppressive and therefore unconstitutional. Judge Norris dissented. In his view, the 1987 amendment was within the wide latitude of congressional authority to legislate retroactively in regulating economic activity. We granted certiorari, 510 U.S. 810 (1993).

II

HN3 This Court repeatedly has upheld retroactive tax legislation against a due process challenge. See, *e. g.*, *United States* v. *Hemme*, 476 U.S. 558, 90 L. Ed. 2d 538, 106 S. Ct. 2071 (1986); *United States* v. *Darusmont*, 449 U.S. 292, 66 L. Ed. 2d 513, 101 S. Ct. 549 (1981); *Welch* v. *Henry*, 305 U.S. 134, 83 L. Ed. 87, 59 S. Ct. 121 (1938); *United States* **[**2022]** v. *Hudson*, 299 U.S. 498, 81 L. Ed. 370, 57 S. Ct. 309 (1937); *Milliken* v. *United States*, 283 U.S. 15, 75 L. Ed. 809, 51 S. Ct. 324 (1931); *Cooper* v. *United States*, 280 U.S. 409, 74 L. Ed. 516, 50 S. Ct. 164 (1930). Some of its decisions have stated that the validity of a retroactive tax provision under the Due Process Clause depends upon whether "retroactive application is so harsh and oppressive as to transgress the constitutional limitation." *Welch* v. *Henry*, 305 U.S. at 147, quoted in *United States* v. *Hemme*, 476 U.S. at 568-569. The "harsh and oppressive" formulation, however, "does not differ from the prohibition against arbitrary and irrational legislation" that applies generally to enactments in the sphere of economic policy. *Pension Benefit Guaranty Corporation* v. *R. A. Gray & Co.*, 467 U.S. 717, 733, 81 L. Ed. 2d 601, 104 S. Ct. 2709 (1984). HN4 The due process standard to be applied to tax statutes with retroactive effect, therefore, is the same as that generally

applicable to retroactive economic legislation:

> "Provided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered **[*31]** by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches . . . .
>
> "To be sure, . . . retroactive legislation does have to meet a burden not faced by legislation that has only future effects. . . . 'The retroactive aspects of legislation, as well as the prospective aspects, must meet the test of due process, and the justifications for the latter may not suffice for the former' . . . . But that burden is met simply by showing that the retroactive application of the legislation is itself justified by a rational legislative purpose." 467 U.S. at 729-730, quoting *Usery* v. *Turner Elkhorn Mining Co.*, 428 U.S. 1, 16-17, 49 L. Ed. 2d 752, 96 S. Ct. 2882 (1976).

There is little doubt that the 1987 amendment to § 2057 was adopted as a curative measure. As enacted in October 1986, § 2057 contained no requirement that the decedent have owned the stock in question to qualify for the ESOP proceeds deduction. As a result, any estate could claim **[***29]** the deduction simply by buying stock in the market and immediately reselling it to an ESOP, thereby obtaining a potentially dramatic reduction in (or even elimination of) the estate tax obligation.

It seems clear that Congress did not contemplate such broad applicability of the deduction when it originally adopted § 2057. That provision was intended to create an "incentive for stockholders to sell their companies to their employees who helped them build the company rather than liquidate, sell to outsiders or have the corporation redeem their shares on behalf of existing shareholders." Joint Committee on Taxation, Tax Reform Proposals: Tax Treatment of Employee Stock Ownership Plans (ESOPs), 99th Cong., 2d Sess., 37 (Joint Comm. Print 1985); see also 132 Cong. Rec. 14507 (1986) (statement of Sen. Long) (§ 2057 "allows . . . an executor to reduce taxes on an estate by one-half by selling the decedent's company to an ESOP"). When Congress initially enacted § 2057, it estimated a revenue loss from the **[*32]** deduction of approximately $ 300 million over a 5-year period. See 133 Cong. Rec. 4145 (1987) (statement of Rep. Rostenkowski); *id.*, at 4293 (statement of Sen. Bentsen). It became evident shortly after passage of the 1986 Act, however, that the expected revenue loss under § 2057 could be as much as $ 7 billion -- over 20 times greater than anticipated -- because the deduction was not limited to situations in which the decedent owned the securities immediately before death. *Ibid.* In introducing the amendment in February 1987, Senator Bentsen observed: "Congress did not intend for estates to be able to claim the deduction by virtue of purchasing stock in the market and simply reselling the stock to an ESOP . . . and Congress certainly did not anticipate a $ 7 billion revenue loss." *Id.*, at 4294. Without the amendment, Senator Bentsen stated, "taxpayers could qualify for the deductions by **[**2023]** engaging in essentially sham transactions." *Ibid.*

We conclude that the 1987 amendment's retroactive application meets the requirements of due process. First, Congress' purpose in enacting the amendment was neither illegitimate nor arbitrary. Congress acted to correct what it reasonably viewed as a mistake in the original 1986 provision that would have created a significant and unanticipated revenue loss. There is no plausible contention that Congress acted with an improper motive, as by targeting estate representatives such as Carlton after deliberately inducing them to engage in ESOP transactions. Congress, of course, might have chosen to make up the unanticipated revenue loss through general prospective taxation, but that choice would have burdened equally "innocent" taxpayers. Instead, it decided to prevent the loss by denying the deduction to those who had made purely tax-motivated stock transfers. We cannot say that its decision

was unreasonable.

Second, Congress acted promptly and established only a modest period of retroactivity. This Court noted in *United States* v. *Darusmont*, 449 U.S. at 296, that Congress "almost without exception" has given general revenue statutes effective **[*33]** dates prior to the dates of actual enactment. This "customary congressional practice" generally has been "confined to short and limited periods required by the **[***30]** practicalities of producing national legislation." *Id.*, at 296-297. In *Welch* v. *Henry*, 305 U.S. 134, 83 L. Ed. 87, 59 S. Ct. 121 (1938), the Court upheld a Wisconsin income tax adopted in 1935 on dividends received in 1933. The Court stated that the "'recent transactions'" to which a tax law may be retroactively applied "must be taken to include the receipt of income during the year of the legislative session preceding that of its enactment." *Id.*, at 150. Here, the actual retroactive effect of the 1987 amendment extended for a period only slightly greater than one year. Moreover, the amendment was proposed by the IRS in January 1987 and by Congress in February 1987, within a few months of § 2057's original enactment.

Respondent Carlton argues that the 1987 amendment violates due process because he specifically and detrimentally relied on the preamendment version of § 2057 in engaging in the MCI stock transactions in December 1986. Although Carlton's reliance is uncontested -- and the reading of the original statute on which he relied appears to have been correct -- his reliance alone is insufficient to establish a constitutional violation. HN5 Tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code. Justice Stone explained in

> *Welch* v. *Henry*, 305 U.S. at 146-147:
> "Taxation is neither a penalty imposed on the taxpayer nor a liability which he assumes by contract. It is but a way of apportioning the cost of government among those who in some measure are privileged to enjoy its benefits and must bear its burdens. Since no citizen enjoys immunity from that burden, its retroactive imposition does not necessarily infringe due process . . . ."

Moreover, the detrimental reliance principle is not limited to retroactive legislation. An entirely prospective change in **[*34]** the law may disturb the relied-upon expectations of individuals, but such a change would not be deemed therefore to be violative of due process.

Similarly, we do not consider respondent Carlton's lack of notice regarding the 1987 amendment to be dispositive. In *Welch* v. *Henry*, the Court upheld the retroactive imposition of a tax despite the absence of advance notice of the legislation. And in *Milliken* v. *United States*, the Court rejected a similar notice argument, declaring that a taxpayer "should be regarded as taking his chances of any increase in the tax burden which might result from carrying out the established policy of taxation." 283 U.S. at 23.

In holding the 1987 amendment unconstitutional, the Court of Appeals relied on this Court's decisions in *Nichols* v. *Coolidge*, 274 U.S. 531, 71 L. Ed. 1184, 47 S. Ct. 710 (1927), **[**2024]** *Blodgett* v. *Holden*, 275 U.S. 142, 72 L. Ed. 206, 48 S. Ct. 105 (1927), and *Untermyer* v. *Anderson*, 276 U.S. 440, 72 L. Ed. 645, 48 S. Ct. 353 (1928). Those cases were decided during an era characterized by exacting review of economic legislation under an approach that "has long since been discarded." *Ferguson* v. *Skrupa*, 372 U.S. 726, 730, 10 L. Ed. 2d 93, 83 S. Ct. 1028 (1963). To the extent that their authority survives, they do not control **[***31]** here. *Blodgett* and *Untermyer*, which involved the Nation's first gift tax, essentially have been limited to situations involving "the creation of a wholly new tax," and their "authority is of limited value in assessing the constitutionality of subsequent amendments that bring about certain changes in operation of the tax laws." *United States* v. *Hemme*, 476 U.S. at 568. *Nichols* involved a novel development in the estate tax which

embraced a transfer that occurred 12 years earlier. The amendment at issue here certainly is not properly characterized as a "wholly new tax," and its period of retroactive effect is limited. Nor do the above cases stand for the proposition that retroactivity is permitted with respect to income taxes, but prohibited with respect to gift and estate taxes. In *Hemme* and *Milliken*, this Court upheld retroactive features of gift and estate taxes.

[*35] III

In focusing exclusively on the taxpayer's notice and reliance, the Court of Appeals held the congressional enactment to an unduly strict standard. Because we conclude that HN6 ↑retroactive application of the 1987 amendment to § 2057 is rationally related to a legitimate legislative purpose, we conclude that the amendment as applied to Carlton's 1986 transactions is consistent with the Due Process Clause.

The judgment of the Court of Appeals is reversed.

It is so ordered.

CONCURBY: O'CONNOR; SCALIA; THOMAS

CONCUR: JUSTICE O'CONNOR, concurring in the judgment.

The unamended 26 U.S.C. § 2057, which allowed taxpayers to reduce the taxable estate by buying securities and reselling them to employee stock ownership plans (ESOP's), made it possible to avoid estate taxes by structuring transactions in a certain way. But the tax laws contain many such provisions. See, *e. g.*, 26 U.S.C. § 2055 (allowing deductions from taxable estate for transfers to the government, charities, and religious organizations). And § 2057 was only the latest in a series of congressional efforts to promote ESOP's by providing tax incentives. See, *e. g.*, 26 U.S.C. § 133 (partial income tax exclusion for interest paid to banks on ESOP loans); 26 U.S.C. § 1042 (allowing certain taxpayers to defer capital gains taxes on sale of securities to ESOP's).

Thus, although respondent Carlton may have made a "purely tax-motivated stock transfer," *ante*, at 32, I do not understand the Court to express any normative disapproval of this course of action. As executor of Willametta Day's estate, it was entirely appropriate for Carlton to seek to reduce the estate taxes. And like all taxpayers, Carlton was entitled to structure the estate's affairs to comply with the tax laws while minimizing tax liability. As Learned Hand observed with characteristic acerbity:

> **[*36]** "[A] transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that **[***32]** his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes. Therefore, if what was done here, was what was intended by [the statute], it is of no consequence that it was all an elaborate scheme to get rid of [estate] taxes, as it certainly was." *Helvering* v. *Gregory*, 69 F.2d 809, 810 (CA2 1934) (citations omitted), aff'd, 293 U.S. 465, 79 L. Ed. 596, 55 S. Ct. 266 (1935).

To say that Carlton did nothing wrong in claiming the deduction does not, of course, answer the question whether Congress deprived **[**2025]** him of due process by amending § 2057. As we have noted, "the retroactive aspects of economic legislation, as well as the prospective aspects, must meet the test of due process: a legitimate legislative purpose

furthered by rational means." *General Motors Corp.* v. *Romein*, 503 U.S. 181, 191, 117 L. Ed. 2d 328, 112 S. Ct. 1105 (1992) (internal quotation marks omitted).

The Court finds it relevant that, according to prominent members of the tax-writing committees of each House, the statute as originally enacted would have cost the Government too much money and would have allowed taxpayers to avoid tax by engaging in sham transactions. See *ante*, at 31-32. Thus, the Court reasons that the amendment to § 2057 served the legislative purpose of "correcting" a "mistake" Congress made the first time. *Ante*, at 32. But this mode of analysis proves too much. Every law touching on an area in which Congress has previously legislated can be said to serve the legislative purpose of fixing a perceived problem with the prior state of affairs -- there is no reason to pass a new law, after all, if the legislators are satisfied with the old one. Moreover, the subjective motivation of Members of Congress in passing a statute -- to the extent it can **[*37]** even be known -- is irrelevant in this context: It is sufficient for due process analysis if there exists *some* legitimate purpose underlying the retroactivity provision. Cf. *FCC* v. *Beach Communications, Inc.*, 508 U.S. 307, 313-315, 124 L. Ed. 2d 211, 113 S. Ct. 2096 (1993).

Retroactive application of revenue measures is rationally related to the legitimate governmental purpose of raising revenue. In enacting revenue measures, retroactivity allows "the legislative body, in the revision of tax laws, to distribute increased costs of government among its taxpayers in the light of present need for revenue and with knowledge of the sources and amounts of the various classes of taxable income during the taxable period preceding revision." *Welch* v. *Henry*, 305 U.S. 134, 149, 83 L. Ed. 87, 59 S. Ct. 121 (1938). For this reason,

> "in enacting general revenue statutes, Congress almost without exception has given each such statute an effective date prior to the date of actual enactment. . . . Usually the 'retroactive' feature has application only to that portion of the current calendar year preceding the date of enactment, but [some statutes have been] applicable to an entire calendar year that had expired preceding enactment. This 'retroactive' application apparently has been confined to short and limited periods required by the practicalities of producing national legislation. We may safely **[***33]** say that it is a customary congressional practice." *United States* v. *Darusmont*, 449 U.S. 292, 296-297, 66 L. Ed. 2d 513, 101 S. Ct. 549 (1981) *(per curiam)*.

But "the Court has never intimated that Congress possesses unlimited power to 'readjust rights and burdens . . . and upset otherwise settled expectations.'" *Connolly* v. *Pension Benefit Guaranty Corporation*, 475 U.S. 211, 229, 89 L. Ed. 2d 166, 106 S. Ct. 1018 (1986) (O'CONNOR, J., concurring) (brackets omitted), quoting *Usery* v. *Turner Elkhorn Mining Co.*, 428 U.S. 1, 16, 49 L. Ed. 2d 752, 96 S. Ct. 2882 (1976). The governmental interest in revising the tax laws must at some point give way to the taxpayer's interest in finality and **[*38]** repose. For example, a "wholly new tax" cannot be imposed retroactively, *United States* v. *Hemme*, 476 U.S. 558, 568, 90 L. Ed. 2d 538, 106 S. Ct. 2071 (1986), even though such a tax would surely serve to raise money. Because the tax consequences of commercial transactions are a relevant, and sometimes dispositive, consideration in a taxpayer's decisions regarding the use of his capital, it is arbitrary to tax transactions that were not subject to taxation at the time the taxpayer entered into them. See *Welch* v. *Henry, supra*, at 147.

Although there is also an element of arbitrariness in retroactively changing the rate of tax to which the transaction is subject, or the availability of a deduction for engaging in that transaction, our cases have recognized that Congress must be able to make such **[**2026]** adjustments in an attempt to equalize actual revenue and projected budgetary

requirements. In every case in which we have upheld a retroactive federal tax statute against due process challenge, however, the law applied retroactively for only a relatively short period prior to enactment. See *United States* v. *Hemme, supra*, at 562 (1 month); *United States* v. *Darusmont, supra*, at 294-295 (10 months); *United States* v. *Hudson*, 299 U.S. 498, 501, 81 L. Ed. 370, 57 S. Ct. 309 (1937) (1 month). In *Welch* v. *Henry, supra*, the tax was enacted in 1935 to reach transactions completed in 1933; but we emphasized that the state legislature met only biannually and it made the revision "at the first opportunity after the tax year in which the income was received." 305 U.S. at 151. A period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise, in my view, serious constitutional questions. But in keeping with Congress' practice of limiting the retroactive effect of revenue measures (a practice that may reflect Congress' sensitivity to the due process problems that would be raised by overreaching), the December 1987 amendment to § 2057 was made retroactive only to October 1986. Given our precedents and the limited period of retroactivity, I concur **[*39]** in the judgment of the Court that applying the amended statute to respondent Carlton did not violate due process.

JUSTICE SCALIA, with whom JUSTICE THOMAS joins, concurring in the judgment.

If I thought that "substantive due process" were a constitutional right rather than an oxymoron, I would think it violated by bait-and-switch taxation. Although there is not much **[***34]** precision in the concept "'harsh and oppressive,'" which is what the Court has adopted as its test of substantive due process unconstitutionality in the field of retroactive tax legislation, see, *e. g., United States* v. *Hemme*, 476 U.S. 558, 568-569, 90 L. Ed. 2d 538, 106 S. Ct. 2071 (1986), quoting *Welch* v. *Henry*, 305 U.S. 134, 147, 83 L. Ed. 87, 59 S. Ct. 121 (1938), surely it would cover a retroactive amendment that cost a taxpayer who relied on the original statute's clear meaning over $ 600,000. Unlike the tax at issue in *Hemme*, here the amendment "without notice, . . . gives a different and more oppressive legal effect to conduct undertaken before enactment of the statute." 476 U.S. at 569.

The Court attempts to minimize the amendment's harshness by characterizing it as "a curative measure," quoting some post-legislation legislative history (another oxymoron) to show that, despite the uncontested plain meaning of the statute, Congress never meant it to apply to stock that was not owned by the decedent at the time of death. See *ante*, at 31-32. I am not sure that whether Congress has treated a citizen oppressively should turn upon whether the oppression was, after all, only Congress' "curing" of its own mistake. Even if it should, however, what was done to respondent here went beyond a "cure." The retroactivity not only hit him with the tax that Congress "meant" to impose originally, but it caused his expenditures incurred in invited reliance upon the earlier law to become worthless. That could have been avoided, of course, by providing a tax credit for such expenditures. Retroactively disallowing the tax benefit **[*40]** that the earlier law offered, without compensating those who incurred expenses in accepting that offer, seems to me harsh and oppressive by any normal measure.

The Court seeks to distinguish our precedents invalidating retroactive taxes by pointing out that they involved the imposition of new taxes rather than a change in tax rates. See *ante*, at 34. But eliminating the specifically promised reward for costly action *after* the action has been taken, and refusing to reimburse the cost, is even more harsh and oppressive, it seems to me, than merely imposing a new tax on past actions. The Court also attempts to soften the impact of the amendment by noting that it involved only "a modest period of retroactivity." *Ante*, at 32. But in the case of a tax-incentive provision, as opposed to a tax on a **[**2027]** continuous activity (like the earning of income), the critical event is the taxpayer's reliance on the incentive, and the key timing issue is whether the change occurs after the reliance; that it occurs immediately after rather than long after renders it no less harsh.

The reasoning the Court applies to uphold the statute in this case guarantees that *all*

retroactive tax laws will henceforth be valid. To pass constitutional muster the retroactive aspects of the statute need only be "rationally related to a legitimate legislative purpose." *Ante*, at 35. Revenue raising is certainly a legitimate legislative purpose, see U.S. Const., Art. I, § 8, cl. 1, and any law that retroactively adds a tax, removes a deduction, or increases a rate rationally furthers **[***35]** that goal. I welcome this recognition that the Due Process Clause does not prevent retroactive taxes, since I believe that the Due Process Clause guarantees *no* substantive rights, but only (as it says) process, see *TXO Production Corp.* v. *Alliance Resources Corp.*, 509 U.S. 443, 470-471, 125 L. Ed. 2d 366, 113 S. Ct. 2711 (1993) (SCALIA, J., concurring in judgment).

I cannot avoid observing, however, two stark discrepancies between today's due process reasoning and the due process reasoning the Court applies to its identification of new so-called **[*41]** fundamental rights, such as the right to structure family living arrangements, see *Moore* v. *East Cleveland*, 431 U.S. 494, 52 L. Ed. 2d 531, 97 S. Ct. 1932 (1977) (plurality opinion), and the right to an abortion, see *Roe* v. *Wade*, 410 U.S. 113, 35 L. Ed. 2d 147, 93 S. Ct. 705 (1973). First and most obviously, where respondent's claimed right to hold onto his property is at issue, the Court upholds the tax amendment because it rationally furthers a legitimate interest; whereas when other claimed rights that the Court deems fundamental are at issue, the Court strikes down laws that concededly promote legitimate interests, *id.*, at 150, 162. Secondly, when it is pointed out that the Court's retroactive-tax ruling today is inconsistent with earlier decisions, see, *e. g., Nichols* v. *Coolidge*, 274 U.S. 531, 71 L. Ed. 1184, 47 S. Ct. 710 (1927); *Blodgett* v. *Holden*, 275 U.S. 142, 72 L. Ed. 206, 48 S. Ct. 105 (1927); *Untermyer* v. *Anderson* , 276 U.S. 440, 72 L. Ed. 645, 48 S. Ct. 353 (1928), the Court dismisses those cases as having been "decided during an era characterized by exacting review of economic legislation under an approach that 'has long since been discarded.'" *Ante*, at 34, quoting *Ferguson* v. *Skrupa*, 372 U.S. 726, 730, 10 L. Ed. 2d 93, 83 S. Ct. 1028 (1963). But *economic* legislation was not the *only* legislation subjected to "exacting review" in those bad old days, and one wonders what principled reason justifies "discarding" that bad old approach *only as to that category*. For the Court continues to rely upon "exacting review" cases of the *Nichols-Blodgett-Untermyer* vintage for its due process "fundamental rights" jurisprudence. See, *e. g., Roe,* 410 U.S. at 152-153, 159 (citing *Meyer* v. *Nebraska*, 262 U.S. 390, 399, 67 L. Ed. 1042, 43 S. Ct. 625 (1923), and *Pierce* v. *Society of Sisters*, 268 U.S. 510, 535, 69 L. Ed. 1070, 45 S. Ct. 571 (1925)); see also *Griswold* v. *Connecticut*, 381 U.S. 479, 483, 14 L. Ed. 2d 510, 85 S. Ct. 1678 (1965) ("We reaffirm the principle of the *Pierce* and the *Meyer* cases").

The picking and choosing among various rights to be accorded "substantive due process" protection is alone enough to arouse suspicion; but the categorical and inexplicable exclusion of so-called "economic rights" (even though the Due Process Clause explicitly applies to "property") unquestionably involves policymaking rather than neutral legal analysis. **[*42]** I would follow the text of the Constitution, which sets forth certain substantive rights that cannot be taken away, and adds, beyond that, a right to due process when life, liberty, or property is to be taken away.

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MEMORANDUM

TO: Brett Kavanaugh

FROM: Joe Matal, Counsel to Senator Kyl

DATE: April 31, 2003

RE: ISCRAA and Congress's Power to Tax

Here are some legal authorities indicating that Congress has the power to apply ISCRAA's excise taxes to MSA fee income received within the last year:

First, as noted in Senator Kyl's speech, the Supreme Court has "repeatedly upheld [moderately] retroactive tax legislation against a due process challenge." United States v. Carlton, 512 U.S. 26, 30-31 (1994); *see id.* at 33 (upholding tax whose "actual retroactive effect * * * extended for a period only slightly greater than one year"). ISCRAA only taxes income received since June 1, 2002 – thus reaching back less than one year.

Second, because ISCRAA is a tax, it does not constitute a taking. As the Supreme Court made clear over a century ago, "neither is taxation for a public purpose, however great, the taking of private property for public use, in the sense of the Constitution." Mobile County v. Kimball, 102 U.S. 691, 703 (1880).

Since that time, the Supreme Court also has made clear that a tax is a tax so long as all of its provisions are adapted to the collection of revenue, and it raises at least a "negligible" amount of money. A tax is not invalid for imposing a "crushing effect" on particular businesses, and Congress's motives in imposing the tax are irrelevant. In short, "[a]s is well known, the constitutional restraints on taxing are few * * * * The remedy for excessive taxation is in the hands of Congress, not the courts." United States v. Kahriger, 345 U.S. 22, 28 (1953), overruled on other grounds, Marchetti v. United States, 88 S.Ct. 697 (1968).

The following authorities speak directly to these points:

- Sonzinsky v. United States, 300 U.S. 506 (1937), involved multiple, punitive federal taxes imposed on the sale of sawed-off shotguns, machineguns, and silencers. The party challenging the tax "insist[ed] that the present levy is not a true tax, but a penalty imposed for the purpose of suppressing traffic in a certain noxious type of firearms, the local regulation of which is reserved to the states because not granted to the national government." Id. at 512. The litigant argued that:

  > [t]he cumulative effect on the distribution of a limited class of firearms, of relatively small value, by the successive imposition of different

> taxes, one on the business of the importer or manufacturer, another on that of the dealer, and a third on the transfer to a buyer, is * * * prohibitive in effect and * * * disclose[s] unmistakably the legislative purpose to regulate rather than to tax.

The Supreme Court did not reject this characterization of the tax's effect. Instead, it simply held that:

> "[A] tax is not any the less a tax because it has a regulatory effect; and it has long been established that an Act of Congress which on its face purports to be an exercise of the taxing power is not any the less so because the tax is burdensome or tends to restrict or suppress the thing taxed.
>
> "Inquiry into the hidden motives which may move Congress to exercise a power constitutionally conferred upon it is beyond the competency of courts. They will not undertake, by collateral inquiry as to the measure of the regulatory effect of a tax, to ascribe to Congress an attempt, under the guise of taxation, to exercise another power denied by the Federal Constitution.
>
> "Here the annual tax of $200 is productive of some revenue. We are not free to speculate as to the motives which moved Congress to impose it, or as to the extent to which it may operate to restrict the activities taxed. As it is not attended by an offensive regulation, and since it operates as a tax, it is within the national taxing power."

Id. at 513-514.

- United States v. Kahriger, 345 U.S. 22 (1953), overruled on other grounds, Marchetti v. United States, 88 S.Ct. 697 (1968), involved a heavy federal tax on gambling proceeds. The party challenging the tax argued that "Congress, under the pretense of exercising its power to tax has attempted to penalize illegal intrastate gambling through the regulatory features of the Act, and has thus infringed the police power which is reserved to the states." Id. at 23 (citation omitted). The litigant argued that "because there is legislative history indicating a congressional motive to suppress wagering, this tax is not a proper exercise of such taxing power." Id. at 27.

  The Court responded:

  > The intent to curtail and hinder, as well as tax, was also manifest in the following cases, and in each of them the tax was upheld: Veazie Bank v. Fenno, 8 Wall. 533, 19 L.Ed. 482 (tax on paper money issued by state banks); McCray v. United States, 195 U.S. 27, 59, (tax on colored oleomargarine); United States v. Doremus, 249 U.S. 86 and Nigro v. United States, 276 U.S. 332 (tax on narcotics);

Sonzinsky v. United States, 300 U.S. 506 (tax on firearms); United States v. Sanchez, 340 U.S. 42 (tax on marihuana)." Id. at 27.

The Court continued: "a federal excise tax does not cease to be valid merely because it discourages or deters the activities taxed. Nor is the tax invalid because the revenue obtained is negligible." Id. at 28 (emphasis added). And to give some indication of what would constitute a negligible tax, the Court noted that it had upheld, in the McCray case, a tax on adulterated butter that collected only $3,501. Id.

The Kahriger Court concluded that:

> "It is axiomatic that the power of Congress to tax is extensive and sometimes falls with crushing effect on businesses deemed unessential or inimical to the public welfare * * * * As is well known, the constitutional restraints on taxing are few * * * * The remedy for excessive taxation is in the hands of Congress, not the courts." Id. See also id. at 30 (noting precedent upholding federal that "obliterated from circulation all state bank notes") (citing Veazie Bank v. Fenno, 8 Wall. 533, 19 L.Ed. 482).

- In more recent years, the Supreme Court has reaffirmed these holdings. See, e.g. Department of Revenue of Montana v. Kurth Ranch, 511 U.S. 767, 779 (1994) ("We have cautioned against invalidating a tax simply because its enforcement might be oppressive or because the legislature's motive was somehow suspect"); Bob Jones University v. Simon, 416 U.S. 725, 741 n.2 (1974) ("It is true that the Court in * * * [the past] drew what it saw at the time as distinctions between regulatory and revenue-raising taxes. But the Court has subsequently abandoned such distinctions"); City of Pittsburgh v. Alco Parking Corp., 417 U.S. 369, 376 (1974) (citing "the oft-repeated principle that the judiciary should not infer a legislative attempt to exercise a forbidden power in the form of a seeming tax from the fact, alone, that the tax appears excessive or even so high as to threaten the existence of an occupation or business").

With regard to ISCRAA, it bears keeping in mind that: 1. ISCRAA on its face is a tax, and all of its provisions are adapted to the rasing of revenue. The fee formula simply determines the amount subject to the tax; the declaratory judgment provisions help to enforce the tax. 2. ISCRAA will raise more than negligible revenue. Even the 200% tax is likely to be paid in some instances – e.g., when it applies to an excess-fee payment that is marginal and minor, and the attorney is loathe to return the amount to the client. The very fact that ISCRAA will draw a revenue score will confirm its constitutional status as a tax. 3. ISCRAA does not impose a "crushing burden" on any business. Its high tax rates are marginal rates, applying only to the excessive portion of the fee. And the ISCRAA fee formula is more generous than what federal courts award to plaintiffs' attorneys in common-fund cases involving judgments of $100 million or more.

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SYMPOSIUM ARTICLE: "WHEN SMOKE GETS IN YOUR EYES": MYTH AND REALITY ABOUT THE SYNTHESIS OF PRIVATE COUNSEL AND PUBLIC CLIENT

John C. Coffee, Jr.

SUMMARY:
... This rule applies with special force to the debate over retention by state attorneys general of private counsel to represent them on a contingent fee basis in the recent litigation against the tobacco industry. ... Increasingly, the lead plaintiff proves to be a state pension fund, which in turn hires a private law firm (indeed many of the same law firms as appeared for plaintiffs in the SAG tobacco litigation) on a contingent fee basis. ... In In re Cendent Corp., which ultimately resulted in the largest class action settlement on record ($ 3.1 billion), one contender for the position of lead counsel charged that two of the lead plaintiffs (the New York State and New York City pension funds) had chosen as their co-lead counsel two law firms that had been major campaign donors to the elected official who had sole discretion over each fund. ... While it may be risky to attribute this increase to the lead plaintiff provision, it is noteworthy that the class action that received the greatest press attention for its "pay-to-play" practices (i.e., Cendant) also resulted in the largest class settlement in history. ... Although there is little evidence as to how they do in these separate suits, a number of empirical studies suggest that the class in a securities class action typically receives only between 5% and 10% of their estimated damages in a settlement. ...

TEXT:
[*241]

Introduction

A recurring fallacy in any debate over legal ethics or public policy is to assume that the particular problem under examination is unique and unprecedented. Expand one's field of vision, and precedents and analogs quickly turn up. This rule applies with special force to the debate over retention by state attorneys general of private counsel to represent them on a contingent fee basis in the recent litigation against the tobacco industry. [1] Because this litigation produced a highly successful outcome, while most private litigation against the tobacco industry has not, some are led to the conclusion that this combination of private counsel and public client is potent, unique, and probably troubling - or, at the least, new and noteworthy.

A wider-angled perspective on contemporary complex litigation suggests, however, that this newness is illusory. Although there are likely efficiencies associated with this combination (as

with most other bargains struck in the market between sophisticated parties), the party most likely to be injured or short-changed by this relationship is not the defendant, but rather the state as a client. Thus, although this brief comment disputes the contentions made by others in this symposium that the combination of private counsel and public client circumvents legislative authority or distorts prosecutorial discretion, it does conclude that there are high agency costs associated with this relationship and that these agency problems justify enhanced ethical restraints.

Two preliminary observations are necessary at the outset. First, the state attorneys general tobacco litigation (SAG tobacco litigation) did generate one major innovation, but it was substantive, rather than procedural. This was the acceptance, at least for purposes of the **tobacco [*242] settlement,** of state standing to sue for recoupment of expenses incurred by the state as the result of injuries suffered by its citizens. When private parties (such as unions and health maintenance organizations) have asserted similar claims, they have been judicially rebuffed on the ground that their injuries were too remote. [2] Hence, tobacco litigation did result in the implicit recognition of a new substantive principle of law that could be extended to related dangerous products (such as handguns or lead paint). Yet, the early evidence is that this principle has encountered stiff judicial resistance outside the context of state tobacco litigation. [3]

Second, on the procedural side, the state tobacco litigation involved the hiring of private counsel on a contingent fee basis by a majority of the state attorneys general. Although some may view this as either ethically dubious or politically dangerous, the one thing it cannot fairly be called is novel. Similar combinations of public and private counsel regularly form in other functionally similar litigation contexts. For example, in the context of federal securities litigation, the Private Securities Litigation Reform Act of 1995 (PSLRA) has given control of securities class actions to a "lead plaintiff," who is defined by the statute to be the person or entity with the largest financial interest in the action. [4]

Increasingly, the lead plaintiff proves to be a state pension fund, which in turn hires a private law firm (indeed many of the same law firms as appeared for plaintiffs in the SAG tobacco litigation) on a contingent fee basis. While federal securities class action litigation is the best example of this union of public entities with private litigation counsel, it is far from the only example. One of the largest and most discussed cases of recent years has been the Justice Department's antitrust litigation against Microsoft Corporation. Not only did the Justice Department hire David Boies as their trial lawyer, [5] but when some of **[*243]** the states refused to accept the settlement reached between Microsoft and the Department of Justice, the State of California retained Brendan Sullivan of Williams & Connolly to challenge the settlement, while the Department of Justice hired Phillip Beck of the litigation boutique, Bartlit, Beck, Herman, Palenchar & Scott, as their counsel. [6] In short, as the stakes got higher, all sides turned to outside counsel.

The point in making this comparison with securities litigation is not simply to challenge the assumption of uniqueness, but rather to identify a database that allows us to assess more cases over a longer time period in order to evaluate both the potential for conflicts and corruption and the performance of this new marriage of convenience between public officials and the private plaintiffs' bar. It also supplies a very different perspective on whether the use of contingent fee litigation is simply a mechanism for subverting legislative oversight and funding.

II. Conflicts of Interest Taxonomy

Conflicts of interests are as inevitable as death and taxes. That they exist only frames the real issue: How should they be dealt with? A brief review of the conflict issues that have been perceived as arising uniquely in SAG tobacco litigation shows that they have also arisen in post-PSLRA securities litigation.

A. Conflicts Over Counsel Selection

The most obvious potential conflict is probably that the state official will select the private counsel most willing to bribe him with either an under-the-table payment or a legally permissible political contribution. [7] The allegation that Texas Attorney General Dan Morales demanded a one million dollar bribe from the private counsel seeking to represent Texas in the SAG tobacco litigation has received prominent press coverage (and is the subject of an on-going criminal investigation), and it exemplifies this quintessential conflict. [8]

[*244] Securities litigation has followed a similar pattern, or at least similar allegations. In In re Cendent Corp., which ultimately resulted in the largest class action settlement on record ($ 3.1 billion), one contender for the position of lead counsel charged that two of the lead plaintiffs (the New York State and New York City pension funds) had chosen as their co-lead counsel two law firms that had been major campaign donors to the elected official who had sole discretion over each fund. [9] In truth, both the New York State Pension Fund and the New York City Pension Fund were each subject to the exclusive control and direction of the New York State Comptroller and New York City Controller, respectively. Although the district court in Cendant refused to accept the contention that a quid pro quo was involved, it is at least curious why one of the two co-lead counsels in Cendant, a major Philadelphia plaintiff's firm, would otherwise wish to contribute to the political campaign fund of the New York State Controller. [10] Presumably, its desire to fund good government could have been satisfied closer to home.

While Cendant was a high profile case, it was not unique. A network of relationships exists between an increasingly national plaintiffs bar and those state officials who have actual control over state and municipal pension funds. A recent survey by one newspaper found law firms in New York and Philadelphia contributed not only to local state and municipal officials who could influence the choice of class counsel on behalf of their pension fund, but they also contributed to both sides in races for state treasurer in distant states. [11] But if the problem seems pervasive, the answers to it are obvious. First, one could select counsel through a competitive bidding process; this is in fact what the Cendant court did, although ostensibly at least for other reasons. Second, one could substitute a non-partisan board of trustees for the elected public official in order to minimize the role of political contributions over counsel selection. Interestingly, several of the states that are most active as lead plaintiffs in securities litigation have **[*245]** such non-partisan boards: California (CalPERS), Wisconsin (SWIB), and Florida.

Both of these solutions are open to criticism. Auctions are controversial and may dissuade state pension funds from serving as lead plaintiffs if they cannot choose their own counsel. Similarly, the suggestion that control by an elected official be replaced by a non-partisan board of trustees may sound overly prophylactic to some. Arguably, to insulate the pension fund in this fashion is far more anti-democratic than it is for an elected official to obtain funding from a non-legislatively approved source. Still, such insulation can be justified by analogy to unelected city managers and civil service bureaucracies on the ground that some governmental functions are inherently professional and non-political. If this principle is accepted, the administration of a pension fund is a clear example that would fall within it.

Nonetheless, the simplest solution may be an ethical one that does not seek to change the structural control over the litigation decision. The American Bar Association (ABA) has adopted the Model Rules of Professional Conduct, which contain Model Rule 7.6 (R.P.C. 7.6), which restricts "pay to play" practices and effectively bars attorneys and law firms from accepting government legal engagements if they made or solicited political contributions "for the purpose of obtaining the business." [12] This rule was largely modeled on an earlier rule imposed by the Securities and Exchange Commission on the municipal securities industry. [13] Yet, at least until this proposed rule becomes effective at the state level, there is reason to

believe that "paying to play" is and will remain the norm in those jurisdictions where the state pension fund is subject to the direct control of elected officials. At present, the evidence suggests that state bar groups are steering clear of the ABA's new ethical rule on "pay-to-play" practices, and hence, a norm of "business as usual" presumably remains in effect in the legal marketplace. Even if the ABA rule were adopted by state bars, its language does not prohibit political contributions or bar the attorney **[*246]** from accepting the engagement--except and unless the contribution was made for the "purpose of obtaining" such engagement. Legal minds will have little difficulty finding this rule inapplicable to the facts of their case, based on the attorney's assertion that his or her motivation was not political.

Within this context, R.P.C. 7.6 will not eliminate conflicts regarding the selection of lead counsel. How serious a problem is this if our principal focus is on the performance of lead counsel? Some evidence suggests that securities class action settlements have been higher since the passage of the PSLRA. While it may be risky to attribute this increase to the lead plaintiff provision, it is noteworthy that the class action that received the greatest press attention for its "pay-to-play" practices (i.e., Cendant) also resulted in the largest class settlement in history. Cynical as it may sound, it seems fair to generalize that the attorneys who donate the most to the state controller of their choice are probably among the most able litigators who are most likely to maximize the state's recovery. "Paying to play" may be a barrier to entry and result in cases being filed that would not otherwise be brought, but it is far less clear that it results systematically in inferior counsel becoming class counsel. Moreover, when class counsel is compensated on the basis of a contingent fee calculated as a percentage of the recovery, class counsel's interests are fairly well aligned with those of the class members that they are seeking to protect. Thus, while contingent fees are often criticized as windfalls, the fairest generalization is that, when determined on a percentage basis, they act as an incentive to motivate the attorney to obtain a larger recovery, and they minimize the perverse incentive that can arise under the lodestar formula [14] to run up hours and then settle on a basis that benefits the attorney more than the class that the attorney represents.

B. Conflicts Between Public and Private Clients

Critics of the SAG tobacco litigation have raised the prospect that the private attorney will face a conflict between the interests of the attorney's private clients and his public clients. Why this might be so is far from clear, as the SAG tobacco litigation did not result in any recovery or other litigation benefits to individual plaintiffs. Nor, in my judgment, were there opportunities in the SAG tobacco litigation to trade off the interests of these two groups. In any event, the possibility of conflicts arising between private and public clients is not **[*247]** unique to tobacco litigation. Indeed, by definition in securities class actions, the private attorney is representing both public and private clients. Inherently, this is precisely what a class action intends, which is the aggregation of the largest possible number of claimants in order to maximize the pressure on the defendant.

Two views are possible about the seriousness of this potential conflict. Those who see it as mild to trivial can point to the fact that the lead plaintiff runs the securities class action; hence, the other class members are subordinate to it. As a factual matter, the accuracy of this assertion is debatable because once the class is certified (and possibly before), the lead plaintiff probably owes a fiduciary duty to the class, and in any event, real control probably belongs to the class counsel. The case law makes clear that the class counsel can in effect fire the client who hired it and reach a settlement over its objections. [15] From the opposite perspective, it can be argued that a real and serious conflict between client and counsel exists as to whether the public entity should elect to serve as a lead plaintiff in a class action or whether it should instead opt out and sue in an individual suit. Here, the interests of the private attorney will clearly favor the class action because class counsel is typically rewarded handsomely by the court in successful class actions. If the typical fee award is somewhere around 30% in securities class actions today, this means that the larger the class (and

hence, the larger the recovery), the larger the fee award to class counsel. [16] Yet large corporations and private institutional investors often opt out and sue individually in the belief that they will do better individually than when their interests are submerged within the class.

Indeed, possibly the most noteworthy fact about the lead plaintiff selection process is that since the passage of the PSLRA, private institutional investors have virtually never volunteered for this role--while they do sometimes opt out and sue individually. Although there is little evidence as to how they do in these separate suits, a number of empirical studies suggest that the class in a securities class action typically receives only between 5% and 10% of their estimated damages **[*248]** in a settlement. [17] There are understandable reasons for this (including exaggerated damage models that ignore the major problem of loss causation in securities litigation), but it is at least a realistic hypothesis that settlements in individual actions would award large claimants, represented by able counsel, much higher damages than the same plaintiffs would receive as their pro rata share of a class action.

Still, if the large client gains by opting out, the contingent **fee** plaintiff's **attorney** almost certainly loses. Suppose the public entity that might serve as lead plaintiff owns 10% of the stock purchase during the class period. At most, it will pay its attorney approximately one third of its recovery in an individual action and if it opts out, this is one third of ten percent (or 3-1/3%). Alternatively, if a large client stays in the class, the class counsel may receive one third of the entire class's recovery (i.e., one third of 100%, or 33-1/3% versus 3-1/3%). Therefore, if an individual suit is a realistic option, a real conflict emerges between the interests of the institutional investor who today serves as lead plaintiff and the interests of class counsel, which conflict "pay to play" practices aggravate.

C. Conflicts Over the Decision to Sue

As noted earlier, a stark contrast exists between the behavior of private institutional investors (who virtually never sue in a class action) and public pension funds (who have been the primary lead plaintiffs since the passage of the PSLRA). Who is right? Mutual funds and insurance companies view class litigation as a wasteful diversion of managerial time, a source of potential liability, and above all, a non-core business activity as to which they lack special expertise. Conversely, state pension fund officials believe they have a fiduciary duty to protect the assets in their pension fund and to sue to recover for fraud.

Exacerbating this difference of opinion is the factor of political contributions. If the State Controller received $ 200,000 in lawful soft money from law firm X, will the State Controller resist the request of that law firm to allow it to represent the state in a class action that the law firm wishes to file alleging securities fraud with the pension fund **[*249]** serving as lead plaintiff. Arguably, the political contribution is the price that the law firm pays to obtain a license to use the state's pension assets for litigation purposes. This incentive could imply that the volume of class litigation in the United States will be inflated by political contributions (i.e., suits that would otherwise not be brought will be brought).

How realistic is this danger? In the context of securities litigation, this scenario seems unlikely. Here, one must recognize that a law suit would probably have been filed in any event because even a 100 share shareholder can file and maintain a securities class action. All that is being disputed is the control of that litigation. Thus, what the political contribution really buys is voting control over litigation that would otherwise still be brought. But in the mass tort or consumer class action contexts, this scenario may be more valid. Finally, the context in which it is most legitimately arguable that political contributions may increase the volume of litigation is parens patriae litigation brought by state attorneys general in non-class action suits. This is the one form of action that could not generally be brought by someone else. But even here, there is one braking force on excessive litigation: the plaintiff's attorney is only compensated if the attorney obtains a recovery. Ironically, the contingent fee here becomes a virtue, not a vice, because it removes any incentive to induce the attorney

general to bring an action that the private attorney would not bring at his own expense. In this light, the danger of excess litigation is greatest when the attorney is compensated on an hourly fee basis.

III. The Political Accountability Arguments

Both critics and supporters seem to agree that "the most persuasive explanation" for why state attorneys general retain private counsel on a contingent fee basis is the "need to bypass the state legislature." [18] Again, I tend to dissent to the extent that I see a more basic motivation. In the context of securities class action litigation, it becomes apparent that the legislature has had little objection to the now prevalent system of self-financing such litigation through contingent fees. The efficiency advantages are simply obvious and overwhelming.

A. The Efficiency Advantages

Let us consider the position of a state pension fund that has incurred losses because of securities fraud. In the alternative, assume **[*250]** that the pension fund has had one small loss of one million dollars on one investment, or that it has suffered a large loss of $ 50 million or more on another investment. In theory, in either case, the pension fund could call on the state attorney general to represent it or it could retain in-house counsel. In the case of the small loss, the retention of in-house counsel is clearly inefficient (either by the pension fund or the state attorney general). It would clearly take multiple lawyers several years to handle the action (or, at least, such is the current elapsed time to reach settlement in most securities class actions), and the one million dollar loss is too small to justify this cost. Hence, it is more efficient to aggregate the small losses of many claimants and sue on a class basis. Only if the pension fund expected a continuing series of small losses would it be sensible to hire an in-house expert on securities litigation, and, even then, the rate of fraud is likely to be highly variable, thus ensuring that there will be peaks and valleys and no continuing steady and even demand for the specialist's services.

The point here is that what makes the class action form and the use of outside counsel attractive is less the small size (and limited funds) of the typical class member than the small size of the typical losses. Ultimately, aggregation of small losses is efficient, and even if the large pension fund or other state agency could afford to sue, it is not efficient to do so.

Now let us consider a larger, more catastrophic loss. Conceivably, if it is not restored, the pension plan may become insolvent. If it is a defined benefit plan, this loss falls on the state, which is ultimately liable for the pension benefits that it has promised to its employees. Even if it were a defined contribution plan, it seems politically inconceivable that a state would not try to compensate such a loss, rather than see its former employees lose their expected retirement income. The state agency could, of course, retain a law firm on either an hourly basis or on a contingent fee basis. What it cannot do is handle the matter on an in-house basis with civil service lawyers who lack the requisite prior experience in a specialized field. This is a standard "make or buy" decision that all economic firms face, and the case for leasing talent from a specialist seems overwhelming here.

This need to lease, rather than buy, specialized legal talent remains true even if the legislature is fully prepared to fund all necessary costs. Even a specialized legal agency, such as the Antitrust Division, recently recognized that "bet your company" cases require a legal superstar and not simply a competent bureaucrat by retaining David Boies in the Microsoft litigation.

[*251] To this point, the case for use of a contingent fee has not yet been made. But now add an additional factor to the example: successful litigation is a long-shot, possibly a ten-to-one. Now, a politically accountable official faces real risks of appearing to waste public funds

on a "wing-and-a-prayer" lawsuit. Indeed, the risks would be even higher if the official had hired an in-house staff to bring the suit because upon its failure, the official would have to fire the now redundant employees and would face criticism for both the costs and the possibly mediocre litigation effort that was made. Predictably, opponents of the elected official would surface to voice these criticisms.

In this light, the greater attraction of a contingent fee contract is that it provides the elected official with a no-risk gamble: heads, we win and the state recovers its losses; tails, we lose, but we incur no out-of-pocket losses and we hired the best people available. Viewed this way, the contingency fee agreement is less an end run around the legislature than a risk sharing arrangement that allocates both economic and political risks from the elected official to the party most able to bear it: namely, the plaintiffs' attorney. Even if the plaintiffs' attorney is made a political scapegoat for the loss, he is better suited to bear this loss as a member of a nationwide bar than is a local elected official. In sum, the desire to avoid legislative oversight may sometimes be there, but the greater motive for use of the contingent fee is political insurance--avoiding the probability of a large one-time loss on longshot litigation.

The one respect in which the class action is different from state attorney general parens patriae litigation is that the contingent fee contract does not control. Rather, the state or federal court must determine a reasonable fee for the class. For the state attorney general, this is further and desirable political insurance. Indeed, to the extent that one believes state attorneys general will be overreached in the fee negotiation process, the argument could well be advanced that the state attorney general should only be able to sue on a contingent fee basis if the action is a class action in order to ensure judicial oversight.

B. The Risk of Political Impasse

Even if the legislature is circumvented by the use of contingency fees, it is not disabled. It can still act to block the parens patriae or recoupment litigation. The critical difference involves on whom the risk of impasse falls. If an appropriation is needed to bring suit, a minority faction in the legislature may be able to block it by any of a variety of tactics, from logrolling to a filibuster. Minority vetoes are a **[*252]** common fact of political life in the legislature. If, however, a legislative appropriation is not necessary, then opponents must assemble an affirmative majority to pass legislation. However, a legislature may still block legislation as the Louisiana Supreme Court recently ruled in upholding legislation that blocked an anti-handgun, parens patriae suit by the City of New Orleans. [19]

IV. Conclusion

In the new marriage of public client and private counsel, substance dominates procedure. This tour of securities litigation suggests that it is the substance of state parens patriae litigation, not its procedure, that should be controversial. Procedurally, the marriage of the private plaintiffs' bar and the state attorneys general makes sense and creates enormous synergy that is beneficial to both sides. The plaintiffs' attorney gains the legitimacy, credibility, and home field advantage that only the state can confer, while the state attorneys general gain specialized human capital that they could not otherwise afford. Most of all, the contingent fee means that the state is essentially compensating the private attorney with lottery tickets. This solves most, but not all, of the political risks for state officials and the residual risk is mitigated if courts must approve the fee as reasonable. Not all attorneys will want such compensation, but those willing to accept it become more motivated and have their interests better aligned with their clients. Even if imperfectly, the contingent fee system works to offset many of the dangers that "pay-to-play" practices otherwise would engender.

FOOTNOTES:

n1. In 1998, some 46 states entered into a Master **Settlement** Agreement with the **tobacco** industry that provided for payments of $ 206 billion to be made to the states over a period of years. See McClendon v. Ga. Dep't of Community Health, 261 F.3d 1252 (11th Cir. 2001) (discussing terms of settlement).

n2. See e.g., SEIU Helath & Welfare Fund v. Phillip Morris, Inc., 249 F.3d 1068 (D.C. Cir. 2001); Ass'n of Wash. Pub. Hosp. Dists. v. Phillip Morris, Inc., 241 F.3d 696 (9th Cir. 2001); Allegheny Cen. Hosp. v. Phillip Morris, Inc., 228 F.3d 429 (3rd Cir. 2000) (finding plaintiffs to lack standing to sue tobacco industry for expenses incurred by them relating to medical and health costs).

n3. See e.g., Camed County Bd. of Chosen Feeholders v. Beretta U.S.A. Corp., 2001 U.S. App. LEXIS 24828 (3rd Cir. Nov. 16, 2001); Hamilton v. Beretta U.S.A. Corp., 264 F.3d 21 (2nd Cir. 2000) (dismissing causes of action against manufacturers of hand guns on grounds of standing, remoteness of injury, and lack of proximate causation).

n4. See Section 21D (a)(3) of the Securities Exchange Act of 1934, 15 U.S.C. Sec. 78 u-4 (a)(3)(B). See also In re Baan Co. Sec. Litig., 186 F.R.D. 214 (D.D.C. 1999) (explaining operation of lead plaintiff provision).

n5. Mr. Boies's experience as a retained private counsel to the Federal government did not begin with the Microsoft litigation. Years earlier, he was retained in an action brought by the Federal Deposit Insurance Corp. against Drexel, Burnham Lambert and Michael Milken, in which Mr. Milken paid a settlement of $ 500 million. See Stephen Labaton, "Counting the Vote: The New Gore Lawyer; A Man Who Vanquished Microsoft Takes on the G.O.P.," N.Y. Times, Nov. 14, 2000, at p. A-23.

n6. See Jonathan Groner, "Sullivan Will Lead California Into Battle Against Microsoft," Nat'l L.J., Nov. 19, 2001, at p A-10.

n7. See McCormick v. United States, 500 U.S. 257 (1991) (holding that a "quid pro quo is necessary for a conviction when an official receives a campaign contribution, regardless of whether it is a legitimate contribution.").

n8. See Mark Curriden, Morales Case May Be Done in January; A.G. in Tobacco Case Has Denied Wrongdoing, The Dallas Morning News, Nov. 5, 2000, at 43A.

n9. See In re Cendant Corp., 182 F.R.D. 144, 146-148 (D.N.J. 1998); see also Diana B. Henriques, Conflicts over Conflicts: Class Action Lawyers Defend Their Political Contributions,

N.Y. Times, July 30, 1998, at D-1.

n10. See Kevin McCoy, Campaign Contributions or Conflicts of Interest, USA Today, Sept. 11, 2001, at 13 (finding that these law firms had contributed nearly $ 100,000 to campaigns for New York State Comptroller since 1999 and had been appointed class counsel in two major class actions in which New York state was serving as lead plaintiff).

n11. Id. at p. 1B. For example, this survey found that the plaintiff firms in New York, Philadelphia, and Boston contributed $ 32,000 to the winner and $ 21,500 to the loser in the last election for Louisiana State Treasurer.

n12. See Model Rules of Professional Conduct, R. 7.6 (1983); see also Malcolm A. Heinicke, The ABA Should Not Delay on Pay-to-Play: Regulating the Political Contributions of Lawyers to Government Officials Who Award Legal Contracts, 49 Stan. L. Rev. 1523, 1526-27 (1997); Samantha M. Cohen, Playing-to-Play Is the New Rule of the Game: A Practical Implication of the Private Securities Litigation Reform Act of 1995, 1999 U. Ill. L. Rev. 1331 (1999).

n13. Rule G-37 was adopted by the Municipal Securities Rulemaking Board in 1994. See Municipal Securities Rulemaking Board, Release No. 34-33868; File No. SR-MSRB-94-2, 59 Fed. Reg. 17621 (April 13, 1994); see also Jon Jordan, The Regulation of "Pay-to-Play" and the Influence of Political Contributions in the Municipal Securities Industry, 1999 Colum. Bus. L. Rev. 489 (1999).

n14. See Lynn Hume, No Action on Pay-to-Play ABA Rule Little Interest in States, The Bond Buyer, September 19, 2000, at http://www.bondbuyer.com.

n15. See Lazy Oil Co. v. Witco Corp., 166 F.3d 581 (3d Cir. 1999); see also John C. Coffee, Class Action Accountability, 100 Colum. L. Rev. 370, 407-410 (2000).

n16. The leading studies of fee awards in securities class actions have been conducted by National Economic Research Associates (NERA), an economic consulting firm. Based on data prior to the passage of the PSLRA, NERA found that the average fee award in securities class actions was 31.71% and the median fee award was 33.33%. See Frederick Dunbar, Todd Foster, Vinita Juneja, Denise Martin, Recent Trends III: What Explains Settlements in Shareholder Class Actions? (NERA, June 1995).

n17. The study finding that the average recovery is securities class actions amounts to only 5% of shareholder losses was conducted by NERA and submitted to Congress during the hearings preceding the passage of the PSLRA. See Frederick Dunbar & Vinita Juneja, Recent Trends II: What Explains Settlement in Shareholder Class Actions? reprinted in Private

Litigation Under the Federal Securities Laws: Hearings Before the Subcommittee on Securities of Senate Committee on Banking, Housing, and Urban Affairs, 103rd Congress, 1st Sess. (June 17 and July 21, 1992) at 739-750. For a review and critique of these other studies, see James Cox, Making Securities Fraud Class Actions Virtuous, 39 Ariz. L. Rev. 497, 501-506 (1997).

n18. See David A. Dana, Public Interest and Private Lawyers: Toward Normative Evaluation of Parens Patriae Litigation By Contingent Fee, 51 DePaul L. Rev. 315, 319 (2001).

n19. See Morial v. Smith & Wesson Corp., 785 So. 2d 1 (La. 2001) (upholding constitutionality of state legislation retroactively blocking lawsuit filed by City of New Orleans to recover costs incurred by the City as a result of citizen use of allegedly dangerous hand guns on the ground that legislation fell within state's police power).

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SECTION: News

TITLE: Feuding Over Fees: Some balk at paying billions to lawyers under **tobacco** deal

AUTHOR: Mark Curriden

TEXT:
When state attorneys general announced on June 20 they had reached a $ 368.5 billion **settlement** agreement with the **tobacco** industry to recover smoking-related health care costs, one group of the negotiating team was conspicuously missing from the spotlight: the trial lawyers.

Now, months later, as the proposed agreement works its way through Congress, the reason the attorneys were kept off center stage has become obvious. The debate over how much they will be paid has become so controversial that it threatens passage of the deal itself, according to lawyers involved in the **tobacco** litigation and members of Congress.

How much could the private plaintiffs lawyers hired by 36 states to sue Big **Tobacco** be paid under their contracts? Estimates in published reports range from $ 14.7 billion, if the national agreement is approved, to $ 34 billion if some of the cases go to trial. The controversy has sparked feuding among the lawyers themselves and promises by some members of Congress to put a cap on the amount of money the lawyers can receive.

Money and Politics

"We always feared that **attorney fees** would become a major political issue, and that is most definitely being realized," says Mississippi Attorney General Mike Moore, who led the **settlement** negotiations for anti-smoking forces.

When the two sides negotiated the global **settlement** in Washington, D.C., they intentionally left out any wording regarding **attorney fees,** says Moore. Instead, they came away with the "understanding" that the industry would pay all legal fees and expenses.

An examination by *The Dallas Morning News* shows that the fee agreements negotiated by the states and the approximately 150 private attorneys they hired would pay amounts ranging from a flat $ 100,000 if there is a **settlement** to 25 percent of any money recovered at trial or in a **settlement.**

Eight of the states promised to pay one-fourth of all winnings, four agreed to pay 15 percent and five promised 10 percent. Nine states negotiated deals that increase the **attorney fees** the longer the case drags on or if the case goes to trial. Many states leave **attorney fees** up to the courts to decide.

Only four states--California, Colorado, New Hampshire and Missouri--are handling their lawsuits with in-house lawyers.

To calculate the amount of **fees** the private **attorneys** could earn under the contracts in a best-case scenario, *The Dallas Morning News* multiplied the top contingency fees specified in each state contract by the amount the state would receive under the formula established in the global **settlement.** The paper did not reduce the amounts by the caps that some states impose if a **settlement** is reached. The total came to $ 34 billion.

The amount does not include fees that would be paid to the plaintiffs lawyers known as the Castano group from New Orleans, whose approximately 30 addiction-based class action lawsuits against the industry would also be settled under the global agreement.

Until now, the largest legal paycheck was the estimated $ 400 million fee collected by Houston trial lawyer Joseph Jamail after winning the Pennzoil-Texaco case in 1985. That may soon be surpassed by the amount paid to the lawyers who won the $ 5.3 billion judgment against Exxon stemming from the Exxon Valdez oil spill. Lawyers in that case, which is still under appeal, say fees would be in the range of $ 1 billion.

House Speaker Newt Gingrich, R-Ga., and other leading Republicans have jumped on the fee issue in the **tobacco** litigation. "The way this **settlement** is proposed now, there are attorneys who will become not millionaires, some of them will become instant billionaires," says Gingrich. "That's just not a justified fee."

Gingrich has endorsed a House Republican proposal to cap **attorney fees** at $ 140 per hour and to reimburse the lawyers for their expenses out of a national fund totaling $ 32 million.

The **tobacco** companies have a different proposal, according to Joe Rice, managing partner at Ness, Motley, Loadholt, Richardson & Poole in Charleston, S.C., a lead negotiator in the global **settlement** discussions. They suggest that three retired judges be appointed to act as arbitrators to review each claim for fees and determine how much the lawyers would get.

The industry would pay **attorney fees** and expenses of up to $ 500 million a year until all amounts are paid, says Rice, whose partner, Ron Motley, represents 30 of the 40 states that have sued the **tobacco** industry. Under this proposal, the **attorney fees** would be paid from a separate fund established by the cigarette makers.

One U.S. senator has already tried to limit fees under the proposed **settlement** but was thwarted by a colleague's amendment.

Sen. Jeff Sessions, R-Ala., introduced a bill limiting fees collected under the deal to $ 250 per hour with a cap of $ 5 million per lawyer. The measure passed by one vote. However, minutes later, Sen. Slade Gorton, R-Wash., amended the bill to exempt all 36 states that have contracts with private lawyers. The Clinton administration has said it opposes such arbitrary limits.

"The deal right now is that the law firms are free to either stick with their contracts or voluntarily agree to the arbitration panel," says Moore. "Obviously, we hope they go with the arbitration panel. That would mean more money going to the states, more money out of the pockets of the **tobacco** companies and less controversy."

"We're talking about a lot of money," says Rice. "The danger is that we trial lawyers come across looking like we are putting our greed ahead of our main concern--making this industry change how it does business and no longer marketing cigarettes to kids."

That perception may have been at play in Florida, when Palm Beach Circuit Judge Harold Cohen refused to enforce the contract to pay the state's hired lawyers 25 percent of an $ 11.3 billion **settlement with tobacco** companies.

The August agreement said fees would be determined by arbitration. Five of the 11 lawyers hired by Florida Attorney General Bob Butterworth demanded that the original contingency fee agreement be enforced and filed a lien against the first $ 750 million the **tobacco** companies paid to the state.

"I've got an ironclad contract that says I'm entitled to 25 percent and I've got a governor and an attorney general who don't want to live up to their commitment," says Robert Montgomery, whose West Palm Beach law firm joined Motley in leading the state's prosecution.

An 'Unconscionable' Outcome

On Nov. 12, Cohen ruled that the liens against the state should be lifted. The judge said the lawyers are entitled to handsome fees but not $ 2.8 billion, which is 25 percent of the recovery.

"The dream team of private lawyers representing the plaintiffs in this case are not members of a professional sports franchise, but are officers of the court and the people's advocate in this case. What may have seemed to be a reasonable and ordinary contract when the case began has now developed into an unconscionable one."

State Attorney General Butterworth agreed with the ruling. "This contract got to be totally excessive," he says. "Nobody, nobody is worth $ 182,000 an hour."

The five lawyers were planning an appeal.

However this controversy plays out, the anti-**tobacco** lawyers say they deserve every penny they get. They point out that the private bar led the industry to the negotiating table and that the state attorneys general did not have the resources for such an undertaking.

"When we started this litigation in 1994, we agreed each of our 60 law firms was going to have to spend about $ 1 million on average and that it would take about seven years before we would see any return," says Russ Herman, a New Orleans lawyer, lead member of the Castano anti-**tobacco** group and a negotiator in the **settlement** talks.

"These lawyers took on an enemy that had never lost in court, had never paid out one dime in damages, and has the most ferocious and highly paid legal defense teams in the world. And we won. We changed how this industry does business."

A Big Payday
Lawyers stand to earn a tremendous amount of money if they collect the full amount specified in their contracts with the 36 states that hired them to sue **tobacco** companies.

. The top amount the attorneys could earn under the contracts: an estimated $ 34 billion

. States that agreed to pay one-fourth of all winnings: Connecticut, Florida, Maryland, Massachusetts, Minnesota, New Jersey, South Carolina and Utah

. States that used their own lawyers to sue **tobacco** companies: California, Colorado, New Hampshire, Missouri

GRAPHIC: Picture 1, Judge Harold Cohen ruled that the lawyers hired by the state of Florida

were officers of the court and not entitled to $ 2.8 billion in fees. PALM BEACH POST; Picture 2, Joe Rice: The objectives are to change Big **Tobacco's** business habits and to stop marketing aimed at kids. ABAJ/WADE SPEES

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