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The naked truth about settling sexual harassment cases

In the #MeToo era, public interest in disclosure clashes with the private value of confidentiality

By Jan Frankel Schau

Times are changing and both employees and employers are taking note: In 2018, sexual harassment is not tolerated. Between the #Me-Too movement and the #TimesUp phenomenon, cases involving sexual harassment are getting noticed and being settled in record number. Yet there is a tension between the desire to settle these claims confidentially and the political will to publicize these offenses in a way that is designed to support victims and deter future misconduct.

Federal tax law changed in 2017 to create a financial disincentive to settling sexual harassment cases under terms that require confidentiality. This movement towards transparency and full disclosure flies in the face of the strict confidentiality protections long afforded to settlement in mediation. So, what does this movement towards disclosure really mean?

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Sign displaying the #MeToo and #timesup message raised at the Women's March in San Francisco, January 20, 2018.

Tax Implications

Last year Congress amended Section 162(q) of the Tax Code, which provides: "No deduction shall be allowed under this chapter for— (1) Any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement, or (2) Attorney fees related to such a settlement or payment."

The change was motivated by a movement towards disclosure, transparency and a political will to make claims of sexual harassment less likely to be kept secret and subject to a nondisclosure agreement in exchange for hush money. However, in the legal community, where many of these claims are settled either before litigation begins, or during the pendency of litigation, but before there is any public disclosure or a legal determination as to liability, this becomes complicated.

Under tax law, before the so-called "Harvey Weinstein tax," employers could deduct the ordinary and necessary expenses, including legal settlements or payments as well as the attorney fees associated with defending them. This meant that although the employer felt the sting of settling employment cases, their settlements were at least deductible as a part of doing business. Not so as to sexual harassment cases anymore.

And while the payout may have been subject to tax as ordinary income to the plaintiff-employee, she was entitled to deduct her attorney fees. Typically, the IRS did not interfere with the tax allocation of a settlement as long as the parties could show that they entered into it as a part of an adversarial relationship, it was negotiated at arm's length, and it was made in good faith. Essentially, the allocation of taxable and non-taxable dollars had to be reasonable and consistent with the alleged claims in the action.

There are several ways that the new tax law affects these settlements. First, the cost to the employer is increased because they can no longer deduct the payout unless they are willing to permit full disclosure of the settlement. Settlement values may be depressed by the desire to deter other suits when the first one has publicly settled at a high value. In the long run, employers may tend to pay less if the terms of the settlement agreement are not confidential.

Second, it is unclear how to characterize the settlement where there are multiple claims, only one of which involves sexual harassment. Can the other claims predominate, and the employer deduct for everything except that small percentage that is allocated to sexual harassment?

Third, the confidentiality of a mediated settlement agreement is not necessarily the same as a "nondisclosure agreement," which is the language contained in the IRS Code. And what if there is a nondisclosure agreement entered into for discovery purposes long before the settlement agreement is entered into?

Finally, it is unclear whether the employee is entitled to deduct her attorney fees from her income when the settlement is paid to her under IRC 162(q). The language of the statute does not differentiate. Although it was undoubtedly designed to punish the employer or accused harasser, the language itself would appear to have a significant financial impact upon the accuser too.

Although some of the language of the amendment is likely to be clarified in the future, for the time being, it creates a financial disincentive to settle these cases in a confidential way on both sides. It creates a burden for employers, who can no longer "expense" any portion of the payout as a business expense, including their own legal fees associated with defending the claim. And it creates a burden for the employee, who will be liable for income tax on the entirety of the amount paid in settlement, without regard to the attorneys' fees she has incurred in bringing the claim.

Evidence Code Confidentiality Protections

One of the key principles of mediation in California is that the participants can feel free to communicate those intimate, personal and yet un-proven details that underlie their claims. Under Evidence Code Section 1119, anything that was said or any admission that was made for the purpose of, or in the course of, or pursuant to a mediation is protected from discovery and admissibility as evidence. Accordingly, with or without an agreement of confidentiality, all mediations have this protection.

The agreements made in a mediation setting are so strictly confidential that the parties must expressly provide that the confidentiality may be waived if necessary to enforce the terms in court. In fact, the mediator herself is deemed "incompetent" to testify in any subsequent civil proceeding under Section 703.5 of the California Evidence Code. For mediators, this gave us a level of comfort knowing that we would never be called upon to "take sides" on a dispute that came before us, and that we would never be asked to accurately recall all that was said — most of which is not memorialized in writing.

If the parties expressly agree that the settlement is not confidential, does the mediator then have the responsibility or even the legal competence to testify as to the negotiations leading up to the settlement or the ultimate settlement terms? Are the statutes that so carefully protect the confidentiality of the mediation process now trumped by the lack of a nondisclosure agreement?

Typically, both sides to employment disputes are accustomed to a confidentiality clause which effectively protects both the negotiations during and in the course of mediation and the outcome from any future disclosure. The confidentiality clause will usually identify a few necessary exclusions

under the law (enforcement of the agreement, information to attorneys and accountants or disclosure where required by other lawful process). Occasionally, the parties may negotiate a specific statement in the event that either party is asked to publicly comment upon the settlement.

Mediators and the parties who engage them know that it is usually in their best interest to call for these type of confidentiality clauses in the settlement of employment related disputes. Yet, this new tax law may confound and obfuscate that process.

Proposed Legislation

Senate Bill 820 would amend Section 1001 of the California Code of Civil Procedure. If passed, it would make any provision in a settlement agreement that prevents the disclosure of factual information related to claims of sexual assault, sexual harassment or harassment or discrimination based on sex void as against public policy and unenforceable in any action entered into on or after January 1, 2019.

Although the bill has not yet passed in California, there are others like it on the horizon and there is likely to be some equivalent law that prohibits an employer from making settlement agreements on account of sexual harassment confidential as a condition to settlement.

Real World Options

While those who favor prohibiting nondisclosure clauses in sexual harassment settlements hold a strong policy value in exposing abusers so that other potential victims as well as those who have been wronged by the same "bad actor" will be aware of these claims, there is a competing value in the privacy of these claims from the victim's point of view. Many parties and their lawyers choose mediation as a means to resolve their disputes because they want to avoid the publicity, anxiety, risk and expense of exposing themselves as well as their adversaries to the open court room. In addition, because ultimately it may mean that the cases settle at lower values, to account for the lack of a tax benefit, the victims and their lawyers may be less satisfied with the outcome where there is a bargained-for confidentiality provision.

Clearly, the intent of the change in the tax code and the proposed California legislation is to prevent secret settlements which may have the effect of discrediting or "hushing" future legitimate claims. Yet the consequences of the strict non-confidentiality of these settlement agreements may adversely affect the employees as well as their employers.

In practical terms, a willingness to maintain confidentiality can often times be a huge incentive and provide leverage for the plaintiff and her lawyer in early settlement negotiations. Typically, these negotiations are entered into at a time when there are still many factual disputes and liability has not been admitted. It is also typical that the employer or its insurance carrier is paying for the misconduct alleged to have been committed by an individual and the "punishment" is inflicted upon the payor, not the harasser himself. Accordingly, the company may be trying to avoid the negative publicity and damage to its reputation that may come from the lawsuit or claim, even though the wrong-doer may already have been disciplined or fired. Causing the company to publicly disclose the claim may be a disincentive for them to settle the lawsuit for what the plaintiff would consider to be a reasonable amount for fear of setting a "floor" for future claims.

In many instances, an employee (or former employee) has a desire to keep their claims confidential so that future employers will not be informed that they brought a legal action against their former employer. Public figures may have a different desire to "clear their name" than private employees. Celebrities who have been victimized by high-profile individuals may have more at stake than less well-known employees, in that they can use their voice for the greater good, calling attention to this practice in certain segments of our society, irrespective of whether they result in litigation or other legal claims.

For most employees of private companies, clearing their own personnel records from any claims of misconduct (which may ultimately be pretextual) so that it does not appear that they were terminated for cause together with payment of damages, perhaps an apology or explanation and perhaps a commitment by the company to make changes so that the misconduct is not repeated is sufficient. In other words, in many instances the victim has an interest in keeping the settlement confidential too.

Let's be clear. Even where the settlement agreement has a clear and enforceable confidentiality agreement, all parties (including the mediator) must comply with a subpoena where it is issued in a criminal proceeding. Also, the parties can negotiate the terms of the scope of the confidentiality agreement such that the victim may testify if any other claims are brought against the same employer and wrongdoer if subpoenaed to do so in a civil trial.

Where both sides want the settlement to be confidential, there are still several good options to consider in the course of the negotiations in a mediation. First, the parties can explicitly allocate a reasonable amount of the damages to claims arising out of sexual harassment. Those will be non-confidential and therefore may still be deducted for tax purposes. This amount must be fair and reasonable, in order to avoid running afoul of the new tax law but does not need to be the predominant cause where the claims are broader than a single cause of action.

Second, the parties can negotiate the terms of the confidentiality and reflect that in their agreement so that it does not rise to the level of a "non-disclosure agreement". For example, the claims and terms of agreement may be disclosed "upon request" by subpoena or in the course of other legal processes but may not be subject to general disclosure via media or other private communication except to a spouse, attorney or accountant.

Third, the parties can cooperate in drafting an approved statement that will constitute the public disclosure if either party is asked. For example, specific language that states that: "The parties to this lawsuit have decided it is in both side's best interest to resolve the pending dispute in order to focus upon business and personal matters. Accordingly, effective immediately, employee has dismissed her claims against Company and any further inquiries should be directed to HR Director."

Finally, the parties can expressly expunge all preliminary non-disclosure agreements but maintain that the terms of the settlement will not be publicized without notice to the Company in advance and an opportunity to craft an acceptable statement to current employees and to the public in that event.

Conclusion

There is little question that public figures should not be able to buy their way out of sexual harassment and assault through nondisclosure agreements. Yet in the context of civil litigation, there is equal justification for preserving the confidentiality that applies to every other type of case which is mediated in California.

Even in 2018, it is often the case that neither the employer nor the employee wants the publicity and embarrassment that comes from a public airing of this type of personal, sometimes even intimate experience. In addition, the employer may be trying to make things right by paying serious settlement money to the plaintiff but will not do so willingly if it may also suffer the public humiliation of disclosing that its employee failed to conduct himself as required by the company's own policies.

Cases will settle more readily and earlier through private mediation if the court of public opinion is not actively weighing in. From the standpoint of the accused harasser, he has an interest in protecting his name and reputation as well as his economic security. For the accuser, she usually has more of an interest in being heard and believed, securing reasonable damages, and moving on with her life in a way that puts this bad experience behind her, not perpetuates it publicly.

These types of cases can be expensive, stressful, contentious and even embarrassing to both employer and employee. The prospect of an early settlement is attractive to both sides as a way to avoid that. Once the accuser "goes public", the employer has less incentive to pay the damages, because it will want to defend itself and its conduct in the public eye before settling.

In the end, parties should continue to analyze the cost/benefit to confidentiality in cases arising from sexual harassment or abuse. New tax laws make confidentiality less financially appealing, but there are still plenty of justifications to keep the agreement confidential when it is achieved in a mediation, just as any other mediated agreement would be.

There are plenty of creative options which may serve to both maximize recovery, minimize the tax consequence and preserve the integrity of the confidential processes. Where both sides are prepared to carefully consider the consequences of a confidentiality agreement, or an express disclaimer of confidentiality, settlements may be more achievable and enforceable than they would be if the new wave of transparency is followed without consideration of the best interests for clients, their lawyers and ultimately the greater public good.


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