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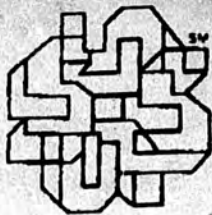
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STRUCTURED SETTLEMENTS: OBJECTION NOTED

by John M. Dangers

I. INTRODUCTION

The United States Congress, Treasury Department, Internal Revenue Service, National Association of Insurance Commissioners, Governmental Accounting Standards Board, and many state legislatures, have, as a matter of public policy, legislated and regulated to promote the use of structured settlements. However, in recent years, plaintiffs have generally responded negatively to structured settlement offers as a result of interest rate fluctuations, and high profile insurer insolvency. In the wake of this resistance, the defense community has become accustomed to the perception that structured settlements are a less viable option than in years past. While security and yield are legitimate, essential issues when contemplating a structured settlement offer, they can be achieved through due diligence. Thus structured settlements remain an appropriate and beneficial method of claim/suit resolution.

II. AN HISTORICAL PERSPECTIVE

When determining the economic advisability of a structured settlement, it is appropriate to consider the yield of a settlement annuity in the context of current market conditions. One yardstick against which to measure financial performance is return relative to the rate of inflation.

A structured settlement may have looked more attractive when double digit interest rates prevailed, and there is no disputing that as interest rates come down, so too does the return on a settlement annuity. However, current

interest rates and investment returns are very close to their long term historical averages.

It is important to realize that in the early 1980's, when settlement annuities were yielding 9 or 10 percent, the rate of inflation was 12 plus percent, resulting in a negative real return of minus 2 or 3 percent. Currently, a typical settlement annuity yields approximately 7 percent and, in relation to the moderate inflation rate (2.7 percent in 1993), produces a positive real return.

Over the last seventy years inflation has averaged 3 percent annually. In its effort to control future inflation, the Federal Reserve recently made a series of preemptive strikes, adjusting short term interest rates upwards. These increases have had a ripple effect into long term interest rates, improving structured settlement returns.

III. THE PRESENT PICTURE AND CRITICAL CONSIDERATIONS

Since 1926 long term interest rates have averaged five percent annually. From this standpoint current rates are actually above average. The perception that interest rates are too low for a structured settlement to be worthy of consideration begs the question: in comparison to what? It is appropriate to make comparisons only against alternative investment opportunities that are available to the plaintiff at the time of settlement.

It is not possible to secure the returns that existed in the past decade, when interest rates were abnormally inflated. The present decade's interest rate declines have had a similar or worse effect on the other investment

vehicles that vary with economic fluctuations, such as US Treasury obligations, municipal bonds, taxable bonds, certificates of deposit, passbook savings accounts, etc.

The critical question, regardless of the state of interest rates, is how can settlement proceeds be invested to achieve a comparable payment stream and the future security that are available in a structured settlement? The answer must take into account various factors, including the injured individual's future earning capacity, investment expertise, and tolerance for risk. Additionally, any such analysis should consider not only nominal returns but also should subtract the rate of inflation and the impact of taxes.

As a result of interest rate trends in recent years, large amounts of money have been transferred from typically conservative savings institutions, which are FDIC insured, into riskier investments, which hold prospects of higher returns. Only months ago, a one year certificate of deposit yielded approximately 3 percent. For a person in the 28 percent tax bracket the after tax yield is reduced to 2.16 percent prior to considering inflation.

Such returns prompted many to seek alternatives with the potential for a greater return, albeit with a proportional increase in risk. However, personal injury claimants typically need a secure payment stream in order to resume as normal a life as may be possible with the knowledge that future medical, personal, and family needs can be accounted for out of settlement proceeds. One way to accomplish this goal is to allocate a portion of the settlement funds to provide for periodic payments. As

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such, these funds would not be subject to speculation, volatility or diminution.

While some sophisticated investors may be able to outperform the fixed return of a structured settlement by engaging in more speculative investments like equities, such gains are not guaranteed and require an individual to risk principal. Additionally, management fees, brokerage fees, taxes, and any other upfront, backend, or ongoing costs associated with an investment diminish investment capital and returns.

IV. DISSIPATION OF LUMP SUM AWARDS

From claimant representatives' and regulators' perspectives, a primary benefit of a structured settlement is that it produces a secure fixed income stream that is guaranteed for life and/or a period certain. As such, a structured settlement can prevent the hardship which often results when a claimant dissipates or outlives lump-sum settlement proceeds.

A study cited by the "Journal of Commerce" found that 90 percent of

the recipients of a substantial lump sum of money whether by settlement or lottery dissipate the entire lump sum within five years of receipt. According to the "California Practice Guide: Personal Injury" 25 to 30 percent of all accident victims dissipate their judgment or settlement within two months of recovery.

This phenomenon is widely recognized, and can be especially problematic in the context of a personal injury, workers compensation, and wrongful death settlements. Once compensatory damages have been squandered, the claimant may be forced to rely on tax-supported public assistance, such as welfare and Medicaid.

V. BENEFITS OF A STRUCTURED SETTLEMENT

A structured settlement provides the opportunity to secure a stable source of in-coming funds so that a claimant may plan a post-accident future. A periodic payment schedule can be specifically tailored to a claimant's individual needs and can be fashioned to replace lost income, provide for the care of

dependents, pay for future medical care, or set up a fund for rehabilitation, retraining, education, or even retirement and estate planning. The payments can be made monthly, quarterly, annually, or can coincide with a future event (e.g., a college fund, mortgage obligation, future surgery and/or rehabilitation, replacement of specialized transportation, etc.). The schedule of periodic payments agreed upon is not subject to inevitable interest rate variation, economic fluctuations, or stock market volatility. As such, the structured settlement's flexibility of design can be very appealing.

VI. TAX CONSIDERATIONS

A principle benefit of structuring a settlement is that the payments flow to the recipient completely tax free in accordance with Section 104(a)(2) of the Internal Revenue Code which states: "*Gross income does not include the amount of any damages received (whether by suit or agreement and whether as lump sum or as periodic payments) on account of personal injury or sickness.*"

Simply stated, personal injury damages are tax exempt. However, Congress and the Internal Revenue Service have created a clear distinction, in the form of a tax exemption, between structured settlement proceeds and those derived from an investment owned or controlled by an individual. Thus, a properly configured structured settlement enables a claimant to enjoy the management-free time value of money without creating a taxable event. Whereas, if an individual accepts a lump sum in resolution of a claim or lawsuit, while that amount is excludable from gross income for tax purposes, any gain derived from investing that lump sum may be subject to federal, state, and local income taxes

INTERNAL RATE OF RETURN COMPARISONS

The chart below demonstrates how much interest the self investor would have to earn to equal the payout of a non-taxable structured settlement. The tax brackets refer to the recipient's federal income tax level. The figures do not include state income taxes, which would make the differences even greater.

Structure Return Rate	15% Tax Bracket	20% Tax Bracket	31% Tax Bracket	36% Tax Bracket
5.00%	5.88%	6.94%	7.25%	7.81%
6.00%	7.06%	8.33%	8.69%	9.38%
7.00%	8.23%	9.72%	10.14%	10.94%
8.00%	9.41%	11.11%	11.59%	12.50%
9.00%	10.60%	12.52%	13.12%	14.06%

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thereby reducing the net return.

In measuring the impact taxes can have, it is important to compare the after tax yield of an alternative investment to that of a tax free structured settlement. Depending upon the applicable tax rate, an individual must obtain a taxable return of between 7.65 and 10.16 percent to match the tax free return from a settlement annuity yielding 6.5 percent.

Unfortunately such returns cannot be achieved by a claimant or any investor in today's marketplace without substantial and perhaps unacceptable exposure to risk.

In lieu of a taxable investment of settlement funds, a claimant may consider municipal bonds. However, like most speculative options, this area can present complications for an unskilled or risk averse investor. While municipal bonds are exempt from federal taxation, they are not necessarily tax free, nor are they risk free. Many municipal bond owners overlook that the interest (or dividends in the case of municipal bond mutual funds) is free from federal income tax, but that tax free status does not necessarily extend to other levies such as capital gains taxes, and state and local taxes.

Additionally, interest risk is inherent in bonds whether they are corporate, U.S., or municipal bonds. The market price of a bond varies inversely with the prevailing interest rates. Therefore, if interest rates increase, as is the current trend, the bond's value decreases. Regardless of market trends, a series of bonds must be purchased to produce a monthly payment stream. Such a portfolio requires management fees, and the exposure to risk, while diversified, is increased by the number of issues held. Also municipals are generally (1) callable within ten years of issuance, exposing investors to rein-

vestment risk, and (2) "downgradeable", potentially subjecting investors to diminished investment quality and security. With many state and local governments operating under fiscal constraints, the prospect of municipal default, while uncommon, is an additional issue of which investors must be aware.

VII. INSURER RELIABILITY

A. What Went Wrong?

Concerns regarding insurer reliability have naturally arisen in the wake of the Executive Life Insurance Company failure and other high profile insolvencies. All indications are that those insurance companies were troubled by imprudent asset management.

Investment practices, such as excessive holdings of non-investment grade ("junk") bonds and real estate holdings that were not geographically diversified, were largely responsible for individual insurer's difficulties.

The Executive Life insolvency occurred because rather than taking the course of steady growth, management opted for explosive uncontrolled asset expansion, creating a portfolio that exceeded 60 percent "junk" bonds. In an effort to continue to attract business prior to being seized by regulators, Executive Life kept its rates below competitive prices, offering greater yields than market conditions dictated. This debacle increased public awareness and scrutiny, and serves as indisputable evidence that cost and yield are not the only determinants of a "good deal".

B. The Solution

Settlement annuity issuers and obligors should be limited to life insurers that exhibit the highest level of security, solvency, and claims paying

ability. If there is any benefit to be derived from industry insolvencies, it is that it has become less difficult to differentiate financially strong from potentially problematic companies. Many insurers have restructured their portfolios in response to the pressure to reduce risk. Consistent with the National Association of Insurance Commissioner's recommendations, the majority of states, Massachusetts included, have passed measures limiting the maximum percentage of non-investment grade assets a licensed insurer may hold. In addition, companies that rate insurer solvency and claims paying ability, such as A.M. Best Company, Standard & Poor's, Moody's, Duff & Phelps, have increased their activity, providing comprehensive assessments of capital adequacy, investment risk, expected future profitability, liquidity, holding company financial leverage, and management on a more frequent basis.

In an effort to combat concerns associated with structuring a settlement, Congress enacted the Technical and Miscellaneous Revenue Act of 1988, repealing a provision of the IRC which provided that the settlement recipient did not have any greater rights against the entity obliged to make the future payments than did a general creditor. Thus, the recipient of periodic payments may exercise the option to perfect a security interest in the settlement annuity, and, in the event of failure, the annuity is pledged to the claimant and payments may not be diverted to the insurer's other creditors.

Implementation of this Act was slowed pending regulatory confirmation that it was truly Congress' intent to allow for secured creditor status without jeopardizing the tax free nature of the periodic payments. The IRS has now issued a pair of letter rulings



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which hold that a plaintiff's possession of an annuity in order to perfect a security interest in the annuity, does not cause the plaintiff any adverse tax consequences. As an alternative, some individual settlement annuity issuers (obligors) offer a corporate guarantee of non-disrupted payments. Any such option should be evaluated by examining guarantee's language and the guarantor's strength.

Recent events have made other security maximization strategies more common. These include the use of U.S. Treasury obligations (alone or in conjunction with a settlement annuity) to fund structured settlement liabilities. Another tact is to divide the structure between two settlement annuity issuers so that a larger aggregate safety net from guaranty associations exist.

VIII. HOW TO OBTAIN A STRUCTURED SETTLEMENT

A structured settlement specialist's services are retained or authorized by the defense, however, objections raised by plaintiff's attorney must be adequately addressed or there will be no structured settlement. The role of the specialist or broker is that of a third-party intermediary and has become increasingly vital to the successful negotiation of a structured settlement. If the specialist cannot sufficiently answer concerns relating to periodic payment schedule design, tax consequences, release language, alternative investment comparison, obligor security and credit worthiness, attorney fee calculation, or any other aspect of a proposed structured settlement, the specialist may not be equipped to provide services in today's more complex mar-

ketplace, or a structured settlement may not be the appropriate solution for the case at hand.

IX. FEE CALCULATION AND DEFERRAL

Contingent fee calculation in the context of a structured settlement is based on the present value of the settlement amount, not the total payout over time. The overwhelming majority rule is that the present value of the current and future payments is the correct measure the settlement for purposes of calculating a contingent fee. In the past there had been some instances in which attorneys based their contingency fee on the settlement payout rather than reducing the settlement amount to its present value, thereby rendering the fee excessive. (Private Reprimand No. 90-34)



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Generally attorney fees are paid out of the up front or immediate cash portion of a structured settlement. There is however the option to structure all or a portion of the fee. By agreeing to accept periodic payments the attorney may be able to defer the tax liability until the year in which funds are received. For years it was somewhat common to structure attorney's fees in conjunction with personal injury settlements. It was widely believed that there was a tax consequence only when those funds were actually received. In 1991 an agent of the Internal Revenue Service during the course of a routine audit challenged the tax deferral of structured attorney fees. The agent argued that where a lawyer accepted a structured fee, he had to pay tax on the present value of the entire income stream in the year that it is earned. The Internal Revenue Service issued a technical advice

memorandum concurring with the agent's argument, resulting in the virtual cessation of structured attorney fees.

A recent case appears to make fee structures a good alternative once again. In *Richard A. Childs, et al. v. Commissioner*, No. 15639-92 (Tax Court, November 14, 1994), the Tax Court rejected the IRS challenge to structured fee arrangements. In the underlying case two settlements were made, both of which included a fee structure. In both, the attorneys' streams of payments were different in timing and amount from the plaintiffs' stream of payments. In neither settlement did the attorneys amend their fee agreements to incorporate periodic payments.

The IRS audited the attorneys for the year of the settlements and attempted to tax the attorneys on the present value of their future payments. The IRS argued that the promise to pay in the

future is "property" and thus currently taxable, if it is funded and secured. The Tax Court said the right of the attorneys to receive future payments was neither funded nor secured, as follows:

"[I]f the...policy is subject to the rights of general creditors of the obligor, funding has not occurred...Since petitioners [the attorneys] did not own the policies, the promises to pay petitioners under the structured agreement were not funded promises."

Additionally the court held that the promise was not secured because it was not backed by any specific fund or property. In a separate attempt to substantiate immediate taxation the IRS argued that the attorneys were in constructive receipt of the fees during the year of settlement. The Tax Court said no:

"it is clear that petitioners [the attorneys] did not constructively

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receive their attorney's fees for each case in the year that case was settled. In the year each structured fee agreement was entered into, there was no money or property available at petitioners' unfettered demand from that structured fee agreement. We hold that petitioners did not constructively receive the fees which were the subject of the structured fee agreements until payments of the amounts in accordance with those agreements."

The IRS has not announced whether it will appeal the Tax Court's ruling. In the interim the following guidelines relative to structured fees for the purpose of tax deferral are advisable. The attorney can be named as the annuitant, but the rights of ownership must be vested in the defendant or the casualty insurer. Additionally, the vehicle which provides for the future payments must not be within the control of

the attorney. This logic is similar to that applied to the plaintiff in that certain restrictions are placed upon the recipient of a structured settlement in order to maintain the tax free nature of personal injury damages paid in the form of periodic payments. Additionally, when the plaintiff's structure is done with a secured-creditor right, attorneys fees should be structured separately without that right.

IX. CONCLUSION

Gone are the days when claims and defense professionals considered structured settlements as "selling themselves". Nevertheless, such settlements have proven and continue to be a viable method of disposition that provide claimants with secure, fixed, management free, tax exempt, appropriately designed compensation. They are an option by which parties can negotiate

an appropriate and mutually satisfactory resolution of claims and lawsuits. ■ *John M. Dangora has been in the structured settlement industry since 1986 and is the founder of Periodic Payment Professionals of Boston which has merged into Niemi Associates, Inc. a national organization of structural settlement professionals. He specializes in addressing concerns and clarifying misunderstandings of the structured settlement concept and has participated in the successful resolution of hundreds of claims/suits nationwide via structured settlement. He instructs a seminar on the subject at the Insurance Library Association of Boston and is currently producing a text book on the structured settlement concept and industry for The Rough Notes Publishing Company. John received his B.A. Economics and B.A. Organizational Behavior and Management at Brown University.*

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