

# Have It Your Way

A structured settlement annuity provides tax-free payments on a customized timetable to a plaintiff. Advisers who ignore the benefits they offer do so at their own peril.

*Gregory Taggart*

**I**N TEXAS, THEY DO THINGS big. Botched surgeries are no exception. Consider the case of Christina Grillo. In a Tarrant County hospital in 1982, Grillo suffered severe injuries at birth, including quadriplegia, blindness, and seizures, all of which were apparently the result of the attending physician's negligence.

As if the newborn's injuries weren't awful enough, what followed compounded her problems. Christina's family filed a medical malpractice lawsuit. A life-care specialist—essentially a financial planner for injured plaintiffs—determined that Christina's constant care would cost about \$20 million from cradle to grave. So initially, it seemed as if her lawyers secured a great deal. The defendants offered a so-called structured settlement that would have paid out more than \$100 million to Christina over her lifetime. Despite the size of the offer, it apparently was not enough for her attorneys and other advisers. They turned down the offer, which would have cost the defendants only \$1.2 million up front—and accepted instead a lump-sum settlement of \$2.5 million.

In less than five years, the funds were exhausted, leaving Christina and her family to face a future without the means to meet her medical needs. Later, the Grillos successfully sued their attorneys and financial representatives for failing to accept the negotiated structured settlement. Sadly, Christina's situation is not unusual, according to Michael Whittenberg, a structured settlement broker



with the James Street Group in Alpine, Utah. "On average, for people who receive a settlement of \$50,000 or less, the money is gone in 90 days," he says. "Those who receive larger cash settlements are broke within five years. It's the same story you hear with lottery winners. Most people just aren't used to handling large sums of money."

Congress passed tax legislation in the early 1980s encouraging structured settlements to protect plaintiffs—especially minors and the catastrophically injured—from squandering money received as damages in a physical-injury lawsuit. Essentially, a structured settlement is a contractual series of periodic payments established before a lawsuit goes to judgment and is tailored to meet the predetermined needs of an injured plaintiff. The planned payment schedule can include a mix of several large distributions and a series of smaller periodic payments to meet virtually any foreseen need, from monthly medical expenses to college tuition, depending on the recipient's needs and circumstances. "Basically, the role of a structured settlement broker is to talk with claimants about their wishes and plans and then try to make that money stretch within the limits of a structured settlement," Whittenberg says.

For example, this is how a broker might structure a \$50,000 settlement for a 5-year-old injured in an auto accident. To pay for the child's ongoing medical needs, the bro-

ker might set up the structure so that the child receives monthly payments that start immediately. To pay for college, a larger payment would arrive on the August 15th following his 18th birthday, just in time for classes. Over the next four to six years, the injured child would get similar payments each August, adjusted for inflation and in time to pay tuition for the upcoming school year. Upon graduation, he could receive a large amount to buy a car as a graduation gift, and at age 30, he would get the rest to use as a down payment on a new home. “A structured settlement annuity is the most wonderful product from a design perspective,” says Karen D. Meyers, a partner in the law firm Little, Meyers & Associates in Cincinnati. “It is totally flexible and doesn’t have any of the tax-code or underwriting restrictions you find in regular annuities.”

The Internal Revenue Service recognized the special needs of physical-injury victims and gave its blessing to structured settlements in 1977 and 1979 with a series of tax-code rulings. Then Congress passed the Periodic Payment Settlement Act of 1982 to turn the IRS’s encouragements into law. Today, the law—Internal Revenue Code Section 104(a)(2)—stipulates that “gross income does not include . . . damages (other than punitive damages) received (whether by suit or agreement and whether



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as lump sums or as periodic payments) *on account of personal physical injury or physical sickness*” (emphasis added). In other words, if the plaintiff’s injury or sickness is the result of the defendant’s wrongdoing, and the defendant settles with him on that basis, the plaintiff’s “qualified” settlement is not reported as income.

However, if a plaintiff’s claim is based on wrongful termination or sexual harassment or some other noninjury offense, any damages received will be “nonqualified” and therefore treated as taxable income to the recipient. The good news is that in such cases, the claimant can still structure the settlement and pay tax on the periodic payments as they are received. “In that sense, a nonqualified structured settlement works more like deferred compensation,” Whittenberg explains.

The words “other than punitive damages” in Sec. 104 signal that only compensatory damages are excludable from income. Punitive damage awards are fully taxable, except in the few cases of wrongful death where state law says that punitive damages are the only remedy. “The reasoning is that punitive damages amount to a private fine and flow from the need to punish the defendant rather than restore plaintiffs to their economic status prior to their injury,” says Salt Lake City attorney Daniel Hindert, coauthor of *Structured Settlements and Periodic Payment Judgments* (Law Journal Seminars Press).

Note also that with “qualified” settlements, the full amount of the payments, including any interest earned prior to when a plaintiff receives a payment, is not taxable. “Once that payment stream is constructed, the full amount of those payments

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is tax-free damages,” says John Stanton, general counsel to the National Structured Settlements Trade Association. Of course, if someone receives structured settlement payments and then invests the funds, any future earnings are taxable.

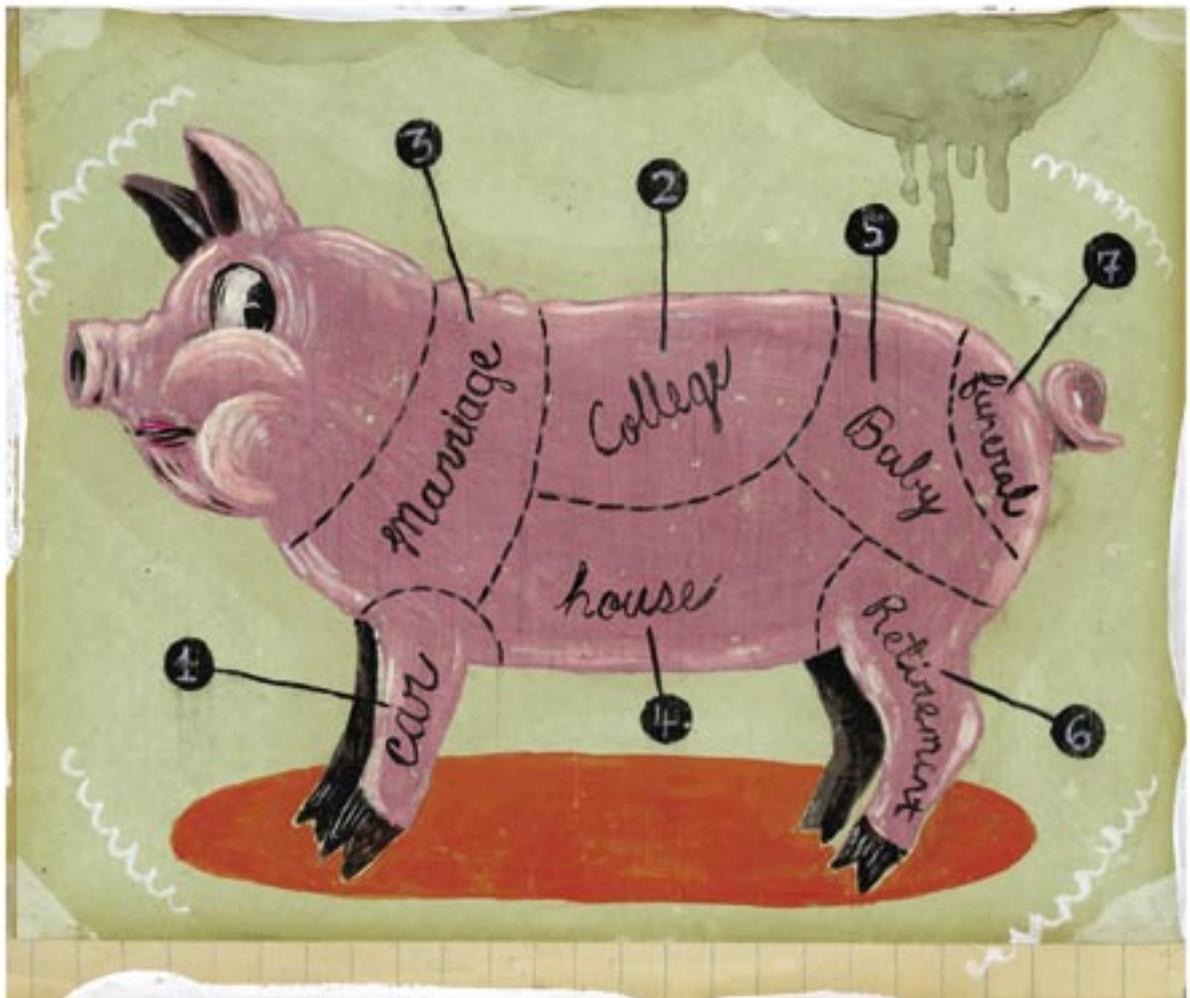
Structured settlements are not estate-tax free, however. For instance, assume an injured minor has a large outstanding structured settlement that is not conditioned on her survival. If she died in the early stage of the settlement payment process and the present value of the remaining periodic payments exceeded her unified credit, her estate could face federal estate-tax and state inheritance-tax liabilities. This can be avoided by either finding a way to move

the payment stream outside of the estate or by purchasing life insurance to cover the tax bill.

“The gravity of this situation requires that it be recognized and considered as early as possible before finalizing any periodic payment settlement or judgment,” Hindert warns.

In many cases, the plaintiff should also consult with an attorney experienced in Social Security, Medicare, and Medicaid issues. Injury awards, including structured settlements, can make the claimant ineligible for these and other government benefits. To guard against that possibility, it might be wise to receive all or part of the award in a supplemental or special-needs trust.

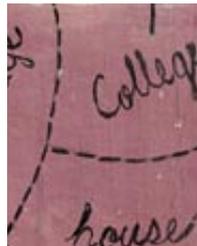
“Structured settlement annuities are the most wonderful products from a design perspective. They are totally flexible.”



In practice, most settlements in injury cases involve both an up-front cash payment and a structured settlement. The defendant, if the plaintiff agrees, may decide to personally finance the periodic payments of the structure, making those payments as they become due. However, because defendants generally want to close the books on a lawsuit and move on, and since most plaintiffs don't want to rely on the defendant's continuing financial health, the usual practice is for the defendant to make a so-called qualified assignment of the obligation to an affiliate of its liability insurer under Sec. 130.

Such assignments qualify if, among other things, the assignee assumes the liability of the defendant or the defendant's insurer, and the liability is funded by either an "obligation of the United States" (presumably U.S. Treasury bills, notes, and bonds) or an annuity contract issued by an insurer. Because of their flexibility and the fact that structured settlement brokers promote them in return for a 4 percent commission, annuities backed by a top-25 life insurance company are by far the preferred funding vehicle.

In fact, insurers have seen structured annuity premiums grow exponentially during the past 30 years, and now total more than \$6 billion, according to Hindert. Though the vast majority of structured annuities provide a fixed-income stream buffered by an inflation rider, MetLife and a few others offer a variable product, according to Meyers. "MetLife got a private-letter ruling on a variable product that meets the definition of a structured annuity," he says.



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Professionals who make fiduciary decisions for their clients cannot afford to ignore the benefits of structured settlements. The Grillo family sued their daughter's attorney and her court-appointed guardian for negligence and legal malpractice, claiming they had not been informed of the defense's structured settlement offer. The child's legal protectors wound up paying \$4.1 million to the family to settle its claim. This time, a good portion of the money went into a structured settlement to ensure that there would be money to pay Christina's bills as long as she lived.

The value of a good adviser in such cases is clear. "The adviser has a role when his or her client has the opportunity to settle an injury claim," says Hindert, who has represented both plaintiffs and defendants. "I always appreciate it as a plaintiff's attorney if there is a qualified financial adviser who can help the claimant make a financial decision about whether to structure and to what extent and how."

Financial advisers involved in these settlements sit at what can be a very large and sometimes confusing table. Structured settlements generally involve many parties, including the plaintiff, the defendant, their attorneys, the defendant's liability insurer, a life insurer (often an affiliate of the liability insurer), a structured

settlement broker who represents—and don't forget this—the defendant's insurer, and sometimes, but not always, a plaintiff's broker. "Defense structured settlement brokers work for the insurers," Mark Wahlstrom, a plaintiff's broker in Scottsdale, Ariz., cautions. "They don't work for the plaintiff, and they have no fiduciary responsibility to him or the plaintiff's attorney. Their job is to save the insurance company money."

They do that by helping their client—the liability insurer—pay less for the annuity than the insurer represented in settlement talks while still making sure that the plaintiff receives the agreed-to income stream. For example, the broker may offer a settlement based on an annuity rate in effect on Thursday, then find a better "daily"

rate on Friday after the settlement, allowing his client to pocket the savings. Or the broker may submit the annuity for medical underwriting after the settlement, hoping that the life insurer will assign the annuitant a rated age, which may increase the internal rate of return to the claimant even as it lowers the liability insurer's settlement costs, a practice called short-changing.

Of course, a reasonable person might ask, "Why should the defendant rather than the plaintiff benefit from the savings?" Wahlstrom thinks the plaintiff should be pocketing the savings and suggests that plaintiffs hire a broker or other expert on a fee basis to evaluate the structured settlement offer. He also recommends asking that defense brokers sign a "Macomber" letter that

## THE LATEST WRINKLE: PLAINTIFF BROKERS

UNLIKE THE LIFE INSURANCE INDUSTRY, where more than 300,000 agents sell the products of more than 1,500 companies, there are fewer than 600 structured settlement brokers nationwide, representing only about 25 life insurance companies that are often captives or subsidiaries of liability insurers. "Historically, most of those have been defense brokers, beholden to the companies that appointed them," says Mark Wahlstrom, a Scottsdale, Ariz., broker. "If a broker represented a plaintiff, they lost their markets, and they were out of the business."

That's changed—somewhat. Today, plaintiff brokers are getting a slice of the pie as the result of legal challenges and laws in some states that require plaintiff attorneys to have an adviser other than a defense broker verify the actual cost of a structured settlement. Nevertheless, the structured settlement industry remains defense-driven, according to Wahlstrom. "Brokers on the plaintiff's side are a very small proportion of the people who are doing this."

That concerns Wahlstrom because he believes plaintiffs (and often their attorneys) have been at the mercy of defense brokers since the first structured settlement. "I have a problem with the way defense brokers don't disclose what

they're doing," he says. "It's just so damn complicated to get accurate information from defense brokers and the insurance companies they represent."

What is often not disclosed, according to attorney Richard Risk, a certified structured settlement consultant, is that defense brokers engage in rebating structured settlement annuity commissions to the liability insurers who purchase the annuities. In addition, liability insurers often engage in short-changing, either by settling a case and then shopping for a better "daily rate" or by assigning a rated age to the annuitant, thus reducing their out-of-pocket cost for the annuity, a saving that goes directly to the insurer's bottom line.

For example, they might agree on settling a case for \$1 million, then find a better "daily rate," or their affiliate life insurance company might assign a rated age to the claimant, thus allowing the liability insurer to buy the annuity for less and pocket the savings. "Self-insured defendants and liability insurers have formed alliances with structured settlement brokerages to create profit centers," Risk alleges. "Over the past two decades, these arrangements have been very profitable."

*Macomber v. Travelers Property Casualty*, a recent and important Connecticut Supreme Court decision, illustrates how

these arrangements work to enrich the insurer and injure the plaintiff even further. Though the numbers in the *Macomber* case were small, the facts are not uncommon in larger cases. One plaintiff in the case alleged that Travelers promised to settle her automobile injury claim for the full policy amount of \$10,000. From that, she paid her attorney \$3,333 (33 percent of \$10,000), and Travelers supposedly invested the remaining \$6,667 in a structured settlement annuity.

In fact, Travelers short-changed her by paying only \$6,569.51 for the annuity—probably by finding a better "daily rate"—and pocketing the difference. In addition, Travelers received a commission rebate of anywhere from 25 to 75 percent of the broker's commission on the annuity sale. In short, the annuity cost Travelers hundreds of dollars less than it represented to the plaintiff. Multiply those hundreds of dollars by thousands of cases, and it amounts to a lot of money for insurers.

And it gets worse for the plaintiff. According to court records, "As a result of [Travelers'] alleged misrepresentation of both the cost and value of the structured settlements, the plaintiffs [also may have] paid their attorneys more than they would have, had they known the true cost and value of their annuities." —GT

requires the broker to disclose whether short-changing or commission rebating is going on, so his client can make an informed decision. (See “The Latest Wrinkle: Plaintiff Brokers, page 42.) Hindert thinks that’s a good approach. “The plaintiff’s attorney may not know or care that there is rebating going on, but forcing that information out is healthy. Better disclosure is all to the good,” he says.

If all else fails, Wahlstrom recommends petitioning the court to establish a so-called Sec. 468B fund, also known as a “designated” or “qualified settlement” fund. Congress created the measure as a mechanism to allow defendants and their insurers to settle claims and receive a current tax deduction for the settlement by paying money into the fund even though other details remained unresolved.

Such funds also work as a place where money can sit while plaintiffs decide what they want to do without having to worry about tax liabilities before they’ve even figured out what to do with the money. Once those decisions are made, the fund administrator can distribute money directly to a plaintiff or to a qualified assignee to purchase a structured settlement annuity—with all of its tax-free aspects intact—and the trust terminates. In the absence of a 468B fund, the defendant is often in charge, and plaintiffs are under pressure to make hurried decisions to accept a structured settlement annuity, often in the dark.

“Essentially, it’s a court-supervised place to park funds,” Hindert says. “And it’s all subject to the light of day. There’s great accountability, and it gives the plaintiffs breathing space, so they don’t have to make hurried decisions.”

The rub is that there is some question whether a single plaintiff can use a 468B to wrest control of a case from the defense broker without triggering a taxable event. The uncertainty has not stopped plaintiff brokers from using a 468B as a lever to force the defense side of the table to disclose the actual cost of an annuity. They rest their case on language in the Treasury regulation 1.468B-1(c) that defines a qualified settlement fund as one “established to resolve or satisfy *one or more* contested or uncontested claims. . . .” (emphasis added). Wahlstrom’s interpretation of the rule is that “one or more means one or more,” whereas Hindert says the issue is less than clear. “I don’t think there’s adequate guidance,

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and personally, I would not use a 468B fund with a single claimant, but I’m conservative.”

In fact, though Wahlstrom has used 468B funds as a lever, he is reluctant to use them for anything other than to handle the cases with many claimants or where there are allocation issues or outstanding liens and other complexities. “You shouldn’t use a 468B simply to control dollars,” he argues. “In fact, I don’t like using them in single-plaintiff cases because they are not worth the additional time and cost to set up.”

Once established, structured settlements are supposed to be permanent and unchangeable. After all, their reason for being is to protect injured plaintiffs from dissipating their funds prematurely. However, if your client’s circumstances change to the point that she no longer needs the protection structured settlements provide, or if you notice a decline in the ratings of the insurance company paying the annuity, your client may want to consider selling her settlement to a factoring company in return for a discounted lump-sum payment, much like in a viatical settlement.

Prior to January 23, 2002, when President Bush signed the Victims of Terrorism Tax Relief Act into law, such transactions were fraught with risk. Many factoring companies preyed on injured plaintiffs, buying their annuities at huge discounts. No more. Today, 38 states have passed laws that require such transactions to pass muster with a judge. And Sec. 5891 imposes a 40 percent excise tax on any person or company who acquires a structured settlement without judicial approval. “This is a very healthy development,” Hindert says.

In fact, the whole idea of structured settlements is healthy. No, they don’t fit every situation, and yes, in some situations, they should probably be mandatory. But in all cases, Wahlstrom cautions, “you’re dealing with some of the most vulnerable, damaged people, and they’re often making lifetime irrevocable decisions on terribly faulty or incomplete information.” Make sure your clients aren’t among them.

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