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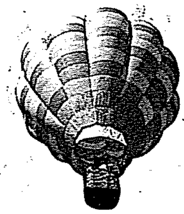

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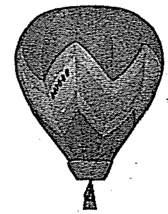

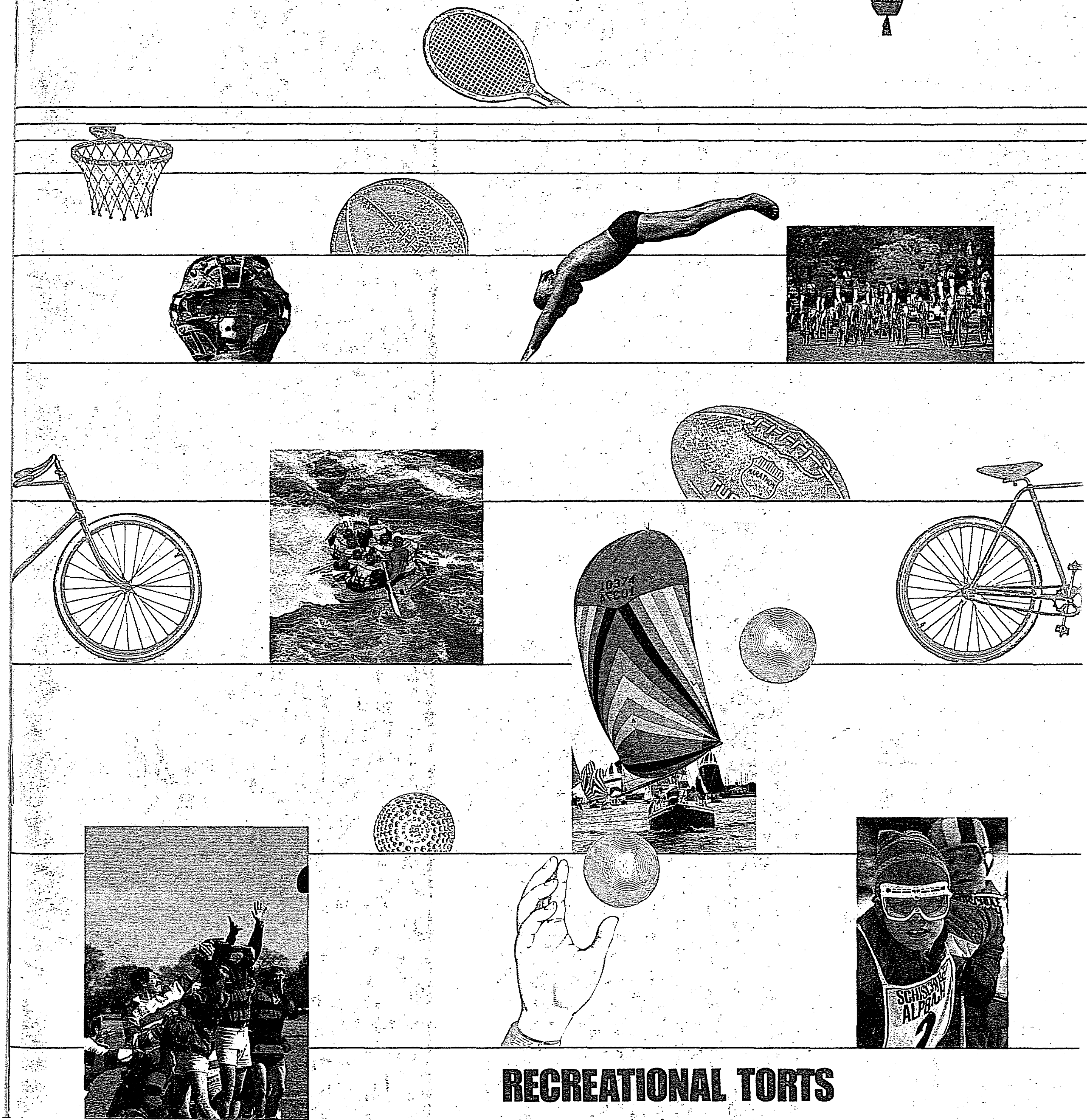

RECREATIONAL TORTS

STRUCTURED SETTLEMENTS:

Protecting the Plaintiff

By James W. Martin

Plaintiffs' lawyers in personal injury and wrongful death lawsuits are becoming increasingly aware of the push for structured settlements by defendants' insurance companies. Numerous articles about structured settlements have recently appeared in legal journals.[1] Many of them, written by insurance counsel,[2] are well written and helpful; however, very little has been written on the plaintiff's behalf as to how to effect the settlement once a structured settlement is chosen. This article will discuss some of the concerns which a plaintiff's lawyer should cover for the client in a structured settlement.

Expert Assistance

Private companies specializing in packaging annuities for insurance companies in structured settlements have been available to defense counsel since at least 1973. They aid the insurance companies in presenting and finalizing a structured settlement. No such companies specialize in the review of such packages for plaintiffs' counsel; therefore, plaintiffs' counsel must seek the assistance of other professionals in reviewing a structured settlement proposal.

Such expert assistance, consisting of an actuary and a tax lawyer or certified public accountant specializing in tax, should be engaged as soon as a structured settlement offer is expected. An actuary not employed by an insurance company usually can be found at a company specializing in administration of pension plans. The actuary should review the proposed settlement to determine the discounted present value of the structured payments and to determine the cost to the defense insurer of the annuity which it will purchase to fund those payments. The actuary thus can provide the plaintiff's lawyer the data necessary to compare the proposed settlement to the usual lump sum settlement. The actuary also can assist in formulating a counteroffer.

The tax lawyer or certified public accountant specializing in tax matters should review the proposed settlement to determine whether the structured settlement payments will be tax-free to the plaintiff or partially taxed. If they are to be taxed, the expert can determine the potential tax impact to the client. The tax expert also should review the written settlement agreement to determine whether its provisions are consistent with tax law if tax-free payments are desired, as they usually are. This tax review is very important since the final decision as to whether a structured settlement is more favorable to the client than a lump sum is often based on the structured settlement payments being tax-free. Thus, if the settlement agreement is written improperly, this important advantage may be lost.

The plaintiff's lawyer should consider engaging an economist to review the proposed structured settlement. Inflation and other economic conditions are always factors in deciding whether to accept a structured settlement. The longer the term of payments, the more important this becomes.

The plaintiff's lawyer may want to engage a business lawyer skilled in drafting contracts to review or draft the settlement agreement. The agreement, usually for a large amount of money to be paid over a long period of time, is actually a contract between the plaintiff and the defendant insurance company. Many contingencies can be anticipated and should be provided for so that the settlement agreement is thorough and complete. Every effort should be made to make the plaintiff as secure about receiving every payment due under the settlement agreement as the plaintiff would have been with a lump sum settlement. (For reasons discussed later, such security would not include being a secured creditor under the Uniform Commercial Code, or the tax benefits may be lost.)

Finally, because a structured settlement may guarantee payments after death, a lawyer experienced in estate planning should be consulted. The settlement often becomes the plaintiff's largest asset, which may make

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estate planning important. In a structured settlement, it is desirable for the estate planner to be involved in drafting the settlement agreement. The estate planner is trained to anticipate and plan for contingencies in the client's financial best interest in a manner that is consistent with the client's overall objectives and estate plan. The estate planning lawyer also may be able to assist with guardianship proceedings for minors or other incompetent plaintiffs.

The above categories of expert assistance needed for negotiating a structured settlement are functional categories, two or more of which may be filled by the same individual. For example, a lawyer may be an expert in tax, business, and estate planning. An actuary may also be an economist or a certified public accountant. Thus, the plaintiff's lawyer may obtain the necessary expert assistance by engaging less than the above number of experts if there are persons qualified in several fields.

Tax Aspects

This brief overview of the tax benefits and requirements of a structured settlement is not a thorough review and should not be used in place of expert tax counsel.

Lump sum amounts received by plaintiffs on account of personal injuries or sickness are not taxable income to the plaintiff whether received in a settlement or after a trial. Section 104 of the Internal Revenue Code provides that gross income does not generally include such damages received on account of personal injuries or sickness. Therefore, if a plaintiff receives a net lump sum recovery of $300,000 for personal injuries, none of that lump sum is taxable; however, the income earned by the plaintiff by investing that $300,000 is taxable just like any other investment.[3] For example, if the plaintiff invests the money in a money market certificate of deposit, the interest earned is taxed as ordinary income to the plaintiff.

In a structured settlement the defendant agrees to pay the plaintiff payments over a period of time. The payments should total more than the case would have settled for in a lump sum, giving the plaintiff the advantage of receiving more than a lump sum settlement, almost as though he or she had invested the lump sum amount and were receiving earnings on it. The defendant has the advantage of not having to pay the full lump sum amount up front.

The primary difference between the plaintiff receiving earnings on a lump sum settlement and receiving a greater total of payments in a structured settlement is that the plaintiff in a properly drafted structured settlement is not taxed on the difference in payments between a lump sum and a structured settlement. Thus, the plaintiff may be able to settle for a $300,000 lump sum and be taxed on earnings of the invested $300,000, or enter into a structured settlement for payments of $2500 a month for life, guaranteed for 20 years, for total guaranteed of $600,000, and not be taxed on the $300,000 received in excess of what the lump sum settlement would have been.[4]

> It is...important to recognize and avoid constructive receipt in drafting a settlement agreement.

However, if the plaintiff has the right to elect the lump sum settlement or the structured settlement, the difference in structured settlement payments may be taxable to the plaintiff because the plaintiff may have constructive receipt of the lump sum amount. It is therefore important to recognize and avoid constructive receipt in drafting the settlement agreement.

The relevant basis for the tax treatment above is Revenue Ruling 79-220, which states that the full amount of monthly payments received in settlement of a damage suit, not just the discounted present value of such payments, is excluded from gross income by section 104(a)(2) of the Internal Revenue Code (IRC).[5] The facts and structure in that ruling can be used as a safe harbor in drafting a settlement agreement. For example, the payments can be for the life of the plaintiff with a guaranteed minimum number of payments and can be payable to the plaintiff's estate if the plaintiff dies before receiving all payments due.[6] The agreement should state specifically that the plaintiff has no right to the discounted present value of the payments and no right to control the investment of that amount. It should also carefully avoid any provision in favor of the plaintiff which would give the plaintiff such rights.

The payments should be funded by the defendant purchasing a single-premium annuity from an insurance company with at least an "A" rating from A.M. Best & Co. The annuity should not be owned by the plaintiff since it is valuable property and would be the same as receipt of a lump sum amount equal to its present value, and all payments in excess of that value could become taxable. The defendant, or anyone not related to the plaintiff, should own the annuity contract and have all rights of ownership, including the right to change the beneficiary. The plaintiff should rely on only the general credit of the defendant for collection of the monthly payments and should not take a security interest in the annuity contract from the defendant. Thus, if the defendant went bankrupt, the annuity contract could become an asset of the bankruptcy, and its annuity payments could go to the receiver.

This adverse result can be minimized by having all defendants in the case join in the settlement agreement and become joint and several obligors, thus guaranteeing all payments. Hopefully, there will be some substantial defendants in addition to the defense insurer. This also provides additional protection in case the insurance company issuing the annuity fails through insolvency or otherwise, as unlikely as that may be if a strong company is selected.

Additional security can be obtained by asking the court to adopt the settlement agreement and enter it as a judgment against the defendants. The plaintiff may then be a judgment creditor, possibly with superior rights.[7]

Thus the plaintiff should have only the right to receive payments in accordance with the defendant's continuing obligation to pay the payments for the agreed period. The defendant's purchase of the annuity contract should be merely an investment by the defendant to provide a source of funds for it to satisfy its obligation to the plaintiff, without giving the plaintiff any rights in the annuity itself. The plaintiff must not have the actual or constructive receipt or the economic benefit of the lump sum amount that was invested by the defendant in the annuity contract to provide the source of payments.

It is interesting to note that Revenue Ruling 79-220 also confirms that payments made to the plaintiff's estate in accordance with a structured settlement agreement are excluded from income under IRC section 104, thus preserving the tax-free benefit to the estate.

Settlement Agreement Draftsmanship

As the above discussion implies, the drafting of a settlement agreement is as important as negotiation of structured payment terms.

The agreement should provide an escalation clause for cost-of-living increases, also called inflation increases. It should not label them as such so that there is no implication that the increases cease if inflation ceases. Such increases are very beneficial, but are usually small percentages that do not actually compensate for inflation. Most insurance companies do not want to agree upon more than a 3 to 6 percent annual increase. Of course, these increases are also tax-free if the structured payments are tax-free.[8]

The agreement should be clear and concise. Language should be consistent throughout. Payment terms should be definite and unambiguous and should be reviewed by the actuary and accountant prior to signing. A date should be specified as an effective date to prevent any ambiguity in determining when payments begin. A schedule of payments should be prepared, verified by the actuary for accuracy based on the payment terms, and attached to the settlement agreement as an exhibit to confirm that the plaintiff only receives periodic payments, the exact amount of those payments, and their due dates.

Default and its effect should be clearly defined in the settlement agreement, just as if it were a sizable mortgage. The agreement should provide a strong incentive against voluntary default by accelerating all payments due in case of default, not by
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[1] Krause, *Structured Settlements for Tort Victims,* 66 A.B.A.J. 1527 (December 1980); Corboy, *Structured Injustice: Compulsory Periodic Payment of Judgments,* 66 A.B.A.J. 1524 (December 1980).

[2] Sedgwick and Judge, *The Use of Annuities in Settlement of Personal Injury Cases,* 41 INS. COUNSEL J. 584 (1974); Verbeck and Michaels, *Structured Settlements and the Uniform Periodic Payments Act,* 29 FED. INS. COUNSEL QTR. 17 (1978).

[3] Revenue Ruling 65–29, 1965–1 C.B. 59.

[4] These amounts are arbitrary and are not meant to imply that the payment amounts in this example are favorable or unfavorable.

[5] Revenue Ruling 79–220, 1979–2 C.B. 74 (I.R.B. 1979–30, 5), involved a structured settlement to a plaintiff for personal injuries to the plaintiff. Payments under a structured settlement by the personal representative of an estate on behalf of the survivors under a wrongful death statute should also be tax-free since payments to estates in other situations for damages relating to death have been excluded under Code Section 104(a) (2) as well. *See* Revenue Ruling 75–45, 1975–1 C.B. 47.

[6] Although it would be convenient to provide in the settlement agreement for the right of the plaintiff to designate a beneficiary other than the plaintiff's estate (such as the plaintiff's *inter vivos* trust), the author could find no rulings or other safe harbors for doing so. It may be best to avoid a constructive receipts argument and omit the right to designate beneficiary, but such a right may possibly be defended on the basis that it is only exercisable on the plaintiff's death and thus is not receipt of a present right.

[7] Security as a judgment creditor was not given to the plaintiff in Revenue Ruling 79–220, but it would not appear to be inconsistent because a judgment is what one expects to obtain from a lawsuit, and IRS Income Tax Regulation § 1.104–1(c) specifically refers to damages through prosecution of a legal suit.

[8] Revenue Ruling 79–313, 1979–2 C.B. 75.