THE EVOLUTION OF STRUCTURED SETTLEMENTS

Rachel D. Grant, CSSC Structured Financial Associates, Inc.
Andrew K. Fisher, CSSC Structures, Inc.

Since 1982, both federal law and IRS regulations have legislatively encouraged plaintiffs to use structured settlement annuities to resolve their physical injury and wrongful death cases. The economic uncertainty that the 2008-09 recession brought has caused a dramatic surge in interest for traditional structured settlements. Plaintiffs and their attorneys use structured settlements to ensure that guaranteed tax-exempt payments act to protect against poor financial management and volatility in the financial markets.

Historically, U.S. law has recognized that personal injury damages should be excluded from taxable income since the Revenue Act of 1918. Section 104(a)(2) of the Internal Revenue Code codified the law, guaranteeing that lump sum monies received for the damages "on account of" physical injury are excluded from gross income. There was, however, no exclusion for interest and investment earnings. In 1983, Public Law 97-473 amended Section 104(a)(2) to allow that the full amount of the future periodic payments from a structured settlement, which consists of both principal and interest, constitute damages and are, therefore, exempt from federal tax liability. In 1997, amendments to the federal tax law expanded the use of structured settlements to include workers' compensation claims [Section 104(a)(1)].

STRUCTURED SETTLEMENTS ARE ALTERNATIVES TO CASH-ONLY NEGOTIATIONS WHICH ALLOW DEFENDANTS TO MATCH SETTLEMENT DOLLARS TO THE FUTURE NEEDS OF A PLAINTIFF. THE CONSERVATIVE NATURE OF TRADITIONAL STRUCTURED SETTLEMENTS HAS GIVEN BIRTH TO THE DEVELOPMENT OF A MARKET-BASED SOLUTION FOR PLAINTIFFS TO CONSIDER WHEN SETTLING THEIR PERSONAL INJURY CLAIM.

With the establishment of Section 130 of the Internal Revenue Code, federal law facilitates the assignment of the obligation to make future periodic payments to a third party. This assignment of a defendant's (or its insurer's) obligation allows the defendant to obtain a full release and close its claim file *and* its future liability to make the periodic payments.

Section 130 mandates that tax-exempt future periodic payments which are assigned must be funded by either life insurance company annuities or U.S. Treasuries, two of the most secure funding sources available. The most common way to fund structured settlements has been and continues to be with fixed annuities from highly rated life insurance companies.

In developing a settlement strategy, a structured settlement offers defense counsel and their clients an alternative to a cash-only negotiation. The "time value of money" principle affords the opportunity to create a variety of payment streams tailored to the plaintiff's specific situation. This focus on future needs can include "period certain" payment streams, payable for a specific period of time immediately or in the future, to provide for specific medical needs, lost earnings, education, scholarship funds, and the like. Lifetime annuities can provide payments for the claimant's life and can be guaranteed for specific periods of time to provide for ongoing compensation to the claimant's surviving beneficiaries.

Further, structured settlement payments should be coordinated with the current and anticipated income sources of the plaintiff. For example, if a plaintiff is currently employed but is concerned about funding his/her children's education goals or their own future retirement plans, an income stream can be set up to start or increase periodic payments at those future dates. If provisions need to be made for a

child's loss of medical insurance coverage under her parents' medical plan, the structured settlement can provide a "fund" to provide for monthly premium payments.

If you are working with workers' compensation claims, the traditional structured settlement is a tried and true method to fund Medicare Set-Aside allocations (MSAs). After the initial "seed" cash deposit, a structured settlement can be set up to fund the Medicare Set-Aside on an annual basis to pay for medical expenses related to the work-related illness or injury. This protects the MSA account from premature consumption and is, therefore, viewed favorably by CMS.

Once the defendants have made settlement offers to a financially savvy plaintiff, there is often a moment in the life cycle of a claim where a structured settlement offer is rejected so that the plaintiff can look to other investments with potentially higher market-related returns. These plaintiffs can afford to take some market risk or may have discretionary settlement dollars because of ongoing employment or previous settlements and may be seeking an all-cash settlement. An innovative method of engaging these plaintiffs in order to bridge the gap between demand and available settlement dollars is essential to effective negotiations.

Settlements Plus™, a market-based solution that offers the plaintiff tax-free or tax-deferred periodic payments with the potential for market-related returns, was created as the next evolution of structured settlements and can serve as an additional settlement tool to augment the traditional structured settlement fixed annuity. Each case is different, and a market-based solution isn't always appropriate; a combination approach may make sense to address future needs and provide upside for discretionary settlement dollars. An open architecture platform allows the plaintiff to choose between passive or active investment strategies that include model portfolio options through the program's master custodian or customized portfolio management through an external financial advisor.

How does this work? Like a traditional structured settlement and in keeping with Section 104(a)(2), the future payments must be fixed and determinable to receive tax-exempt or tax-deferred status (physical injury or non-physical injury settlement). At the time of the settlement, the plaintiff decides the amount of the initial investment and the frequency of payments (including quarterly, semi-annually, annually and/or lump sums). While lifetime payments are not allowed, payments can be scheduled through normal life expectancy. As with traditional structured settlements, the defendant/insurer must agree to fund, and a proper release (with applicable payment language) and assignment agreement must be executed.

So how does defense counsel and her/his client utilize these tools to their full advantage to settle a case and close their respective files?

Recently, a structured settlement Consultant was involved in settlement negotiations on the auto accident claim for a 9-year-old girl. "Jenny" sustained significant damage to her spinal cord, resulting in a compromised life expectancy. Plaintiff's counsel's case evaluation was $50 million, including a medical lien in excess of $1 million. The parties ultimately resolved the claim for $4 million. Jenny's parents were professionals with advanced degrees, and her attorney was sophisticated. A Special Needs Trust was established to ensure that the settlement proceeds will be most effectively utilized to provide for Jenny's lifetime medical and living needs, including home modifications.

When the Consultant prepared traditional structured settlement proposals at the total settlement amount of $4 million, she allocated $2 million for an immediate cash payment (for payment of the negotiated lien, attorney's fees and costs) and $2 million to be invested into the structured settlement annuity to provide lifetime monthly income for Jenny. The annuity generated lifetime monthly income of $7,261 per month, with a guaranteed return of $2,004,304 during the 23-year guarantee period.

Because this proposal generated an internal rate of return of less than 4%, Jenny's parents were interested in taking a less conservative approach to providing for their daughter's long-term needs and opted to combine the traditional structured settlement annuity with a market-based plan.

Utilizing the $4 million settlement amount, an immediate cash payment of $2,105,686 was allocated for payment of the attorney's fees and the negotiated lien amount, as well as providing seed money for the Special Needs Trust. The settlement incorporated a traditional structured settlement with a present value of $894,314, which generated $1,020,000 over its guaranteed 10-year period. The parents sought advice from their financial advisor and opted to have an additional $1 million allocated to a market-based plan, which provided for payments to begin after traditional structured settlement payments (in 11 years) and had a payout period of an additional 20 years.

In total, the hybrid plan that Jenny's parents chose, pairing the traditional structured settlement with a market-based settlement solution, is anticipated to generate in excess of $5.3 million to provide for Jenny's care and keeping over the next 30 years.

Guaranteed payments are extremely important when developing a settlement plan and are instrumental in addressing the future needs of an injured plaintiff. For this reason alone, a traditional structured settlement annuity should be considered the bedrock of the plaintiff's long-term financial plan.

Just as defendants and their counsel continue to seek state-of-the-art discovery and trial tools, structured settlements and market-based solutions should be considered as instruments to be utilized to obtain the best settlement results in their claims settlements practice.

Structured Financial Associates, Inc. and its affiliates (collectively, "SFA") does not provide advice or services related to the purchasing of, selling of, or investing in securities or other financial instruments. Any discussion of securities contained herein is not intended or written to be used, and cannot be used, as advice related to the purchasing of, selling of, or investing in securities or other financial instruments. SFA does not provide legal, tax, or accounting advice or services. Any discussion of legal or tax matters contained herein is for illustrative purposes only and is not intended or written to be used, and cannot be used, as legal advice or for avoiding any penalties that may be imposed under Federal tax laws.

Rachel D. Grant, CSSC is a Certified Structured Settlement Consultant with Structured Financial Associates (SFA), USLAW's exclusive structured settlement corporate partner. SFA is an Integrated Financial Settlements company. She has 25 years' experience in the structured settlement business, specializing in complex litigation, including medical malpractice, transportation and workers' compensation. Rachel also serves as SFA's Director of Communication. She can be reached at rgrant@sfainc.com

Andrew K. Fisher, CSSC is a Vice President of Sales & Marketing in the Atlanta office of Structures (an Integrated Financial Settlements company). He supports IFS agencies with unique insurance-based and market-based settlement solutions. He is a member of the National Structured Settlements Trade Association with the Certified Structured Settlement Consultant (CSSC) designation. Andrew can be reached at afisher@structures.com.