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## Structured Settlements: The Ongoing Evolution from a Liability Insurer's Ploy to an Injury Victim's Boon

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## COMMENT

### **STRUCTURED SETTLEMENTS: THE ONGOING EVOLUTION FROM A LIABILITY INSURER'S PLOY TO AN INJURY VICTIM'S BOON**

#### I. INTRODUCTION\*

Now into its third decade, the structured settlement<sup>1</sup> has earned its place as an integral part of the negotiation process in settling tort type claims for personal physical injury or physical sickness and, to a lesser extent, for workers' compensation claims. As defined by *Black's Law Dictionary*, a structured settlement is a "settlement in which the defendant agrees to pay periodic sums to the plaintiff for a specified time."<sup>2</sup>

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1. The IRS has preferred the all-inclusive term "periodic payment" in addressing tax consequences of payments from both judgments and settlements, rather than "structured settlement." See 26 U.S.C.A. § 104(a), 130 (West 2000). However, the latter term has appeared in recent rulings. No one seems to know for sure who coined the term "structured settlement."

2. BLACK'S LAW DICTIONARY 1377 (7<sup>th</sup> ed. 1999). Black's definition is by no means inclusive, because future payments can be specified for a period certain, with no life contingency, and can include, in addition to the lump sum paid at the time of settlement, lump sums on other specified dates.

### A. *Why Are Structured Settlements Popular?*

Structured settlements enjoy several popular advantages. Among the advantages are income tax-free payments, spendthrift protection, guaranteed income for life, bankruptcy protection for future income and relief from guardianship burdens for minors and incompetents. Additionally, the unsophisticated investor need make no investment decisions, and the sophisticated investor can use "dollar cost averaging" as an investment strategy.

First among these popular advantages is that the tax-free damage payment for a personal physical injury or physical sickness tort claim or workers' compensation claim is extended not just to the money paid by the released party, but to all the growth of that money while it is in the possession of the party responsible for making future payments.<sup>3</sup> If some payments are deferred, all of the internal growth of the annuity is paid out to the claimant free of any income tax obligation. If all the money is paid at once, only the cash settlement amount is income tax-free. The first dollar earned on the damage proceeds, once handed over to the claimant or otherwise constructively received,<sup>4</sup> is a taxable event.<sup>5</sup> For

3. See generally 26 U.S.C.A. § 104(a) (West 2000).

4. Constructive receipt is the doctrine that taxes income before the income is actually received.

Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

Treas. Reg. § 1.451-2(a) (as amended in 1979).

5. The exclusion of workers' compensation (previously known by its gender-specific equivalent, workmen's compensation) and physical injury claim payments is codified in section 104 of the Internal Revenue Code of 1986 ("Code"). 26 U.S.C.A. § 104 (West 2000). The Periodic Payment Settlement Tax Act of 1982 amended section 104 to allow the recipient to exclude from gross income all of the payments from a suit or agreement, whether paid all at once or in the future. Periodic Payment Settlement Act of 1982, Pub. L. No. 97-473, § 101, 96 Stat. 2605 (1983). The Small Business Job Protection Act of 1996 inserted the word "physical" into the Code in describing injury or sickness, and removed punitive damages from the exclusion. The Small Business Job Protection Act of 1996, Pub. L. No. 104-188, §1605(a)-(c), 110 Stat. 1838.

The text of U.S.C.A. § 104 is excerpted as follows:

(a) In General: Except in the case of amounts attributable (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for prior taxable year, gross income does not include:

(1) amounts received under workmen's compensation acts as compensation for personal injuries or sickness;

(2) the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness. . .

For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness. The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care (described in subparagraph (A) or (B) of section 213(d)(1)) attributable to emotional distress.

26 U.S.C.A., § 104(a)(1)-(2), (5) (2000).

This is amplified in Treasury Regulations (also known as Income Tax Regulations and 26 C.F.R. § 1.104-1(c) (2000)). The term "damages received (whether by suit or agreement)" means an amount received through prosecution of a legal suit or action based upon tort or tort type rights, or through a

example, if the funding asset costs \$1 million and the lifetime payout from that asset is \$2 million, then the whole \$2 million is free from income tax. If the plaintiff takes the \$1 million as a cash lump sum instead, that part is free from income tax. However, the first dollar earned on the \$1 million is a taxable event. By taking the \$1 million in a structured settlement, the income taxes on the second \$1 million are avoided.<sup>6</sup>

Second, the releasor receives spendthrift protection from dissipation of the money due to the payee's bad judgment, bad advice from friends and relatives, bad habits, bad company or just plain bad luck. It is widely stated within the structured settlement industry that some evidence suggests many claimants who receive lump sum awards dissipate them fairly quickly.<sup>7</sup>

Third, an annuity can guarantee the money will not be exhausted during the payee's lifetime. Controversy between the plaintiff and defendant over the injury victim's life expectancy can be resolved by transferring that mortality risk to the life insurance company issuing the annuity. When the life expectancy of the payee is lower than for a person in good health, the life insurance company can assign a "rated age" based on medical history.<sup>8</sup>

Fourth, a structured settlement can survive bankruptcy. At least two federal bankruptcy courts in recent decisions have exempted future payments from the bankruptcy estate, shielding the payments from creditors.<sup>9</sup>

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settlement agreement entered into in lieu of such prosecution. *Id.* Unless otherwise provided by law, gross income means all income from whatever source derived, as per 26 U.S.C.A. § 61(a) (West 2000).

6. See generally Richard B. Risk, *Cash Settlement Instead of Structure Means Claimant Gives Up Tax Break*, TRIAL TALK, Mar. 1998, at 21.

7. Nat'l. Structured Settlement Trade Ass'n, *What is a Structured Settlement?...And Other Questions About Structured Settlement Industry*, (May 1997) (distributed at NSSTA's annual meeting).

8. A "rated age" is a hypothetical age assigned to a prospective annuity measuring life by medical underwriters, based on any factor in the person's health history that statistically reflects a shorter life expectancy. For example, a fifty year old male might be assigned a rated age of 65, meaning that the person has a life expectancy of a sixty-five year old male, which is shorter than that of a relatively healthy 50 year old male. This is also called a "rate up" of fifteen years. The condition warranting the rated age does not need to be related to the incident that gave rise to the physical injury or sickness claim. Anything in a person's health history is a factor to be considered. If an annuity is to make guaranteed payments for the annuitant's lifetime, the cost should be less to provide that same benefit for someone with an impaired life expectancy than for a healthy person. That is what is called "mortality risk," and life insurance companies are in the business of assuming it. For the same premium amount, a person with a rate up will receive higher monthly benefits than will a person in good health of the same chronological age. This is just the opposite of life insurance underwriting, when the premium to insure someone with health problems costs more. See generally Richard B. Risk, *Impaired Life Expectancy of Claimant Often Becomes Obstacle to Settlement: Medical Underwriting Can Provide the Solution*, IN BRIEF, Sept. - Oct. 1997, at 17.

9. Debtors were allowed to keep their structure payments in a ruling by the U.S. Bankruptcy Court for the Northern District of Texas, Lubbock Division, entered in December 10, 1998. *In re Alexander*, 227 B.R. 658 (N.D. Tex. 1998). They had lost their two children in 1989 and were receiving periodic payments through a qualified assignment of the future payment liability to Capital Assignment Corporation, which had purchased an annuity from Commonwealth Life Insurance Company. *Id.*

Another debtor was allowed to keep his structured settlement payments from Manufacturers Life Insurance Company for the accidental death of his first wife after filing bankruptcy. *In re Belue*, 238 B.R. 218 (S.D. Fla. 1999).

However, bankruptcy will not discharge the debt if the intent is to defraud settlement purchasers from recovering the amount they advanced. *In re Brooks*, 238 B.R. 218, No. GG 99-07513, 2000 Bankr. Lexis 212 (W.D. Mich. 2000). In this case, an injury victim's attempt to discharge his debt in

Fifth, a structure can relieve a guardian from income tax returns and annual court reporting, usually required in most states for monies recovered on behalf of a minor. If payments are deferred through a structured settlement until the payee reaches majority age, usually 18, there may be no regular accounting to the court once the court approves the structured settlement on behalf of the minor.

Sixth, a structure relieves the unsophisticated investor's burden of managing a large amount of money and other assets, which must last a lifetime. The investor otherwise must worry about fluctuations in the net asset value of the portfolio caused by market changes, including depletion of assets due to bad investments. If the fixed annuity contains life-contingent payments, both payment's size and lifetime duration are guaranteed by the life insurance company, which assumes the mortality risk as well as the investment risk and guarantees payments with its own reserves regardless of the market's performance.<sup>10</sup>

Seventh, for the sophisticated investor, a structured settlement with monthly payments allows for "dollar cost averaging" as a taxable reinvestment strategy. Under this concept, the tax-free periodic payments are reinvested in a given security, usually subject to income tax, at regular intervals on the theory that this is better than "market timing," which is the second-guessing of what the market is about to do.<sup>11</sup>

On the other hand, critics pinpoint structured settlements' inflexibility as a disadvantage. But, for those payees mentioned earlier who might otherwise be inclined to dissipate a large settlement, inflexibility also means indestructibility. Other claimants who have a tolerance for market risk believe they can do better than an annuity's guaranteed rate of return by taking a cash settlement and investing in potentially higher yielding equities. In the past, this may have been a disadvantage of a structure. But, the recent IRS approval of the variable annuity as a qualified funding asset negates that argument.<sup>12</sup> A variable annuity can be invested in equities, giving the claimant the benefit of market growth, which will be entirely income tax-free. The downside, of course, is that the equity portfolio might do worse than the rate of return guaranteed by a single-premium fixed annuity.

### *B. Two Dynamics at Work*

This note reviews two dynamics at work during the structured settlement's two-decade history. It will cover the growth and subsequent stagnation of the industry, including product improvement and tax law changes invented by necessity. This note will also describe how liability insurance claims people and annuity purveyors turned structured settlements into a defense tactic over the

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bankruptcy, after selling future periodic payments from a structured settlement, from First Colony Life Insurance Company, to a factoring company, was denied by the U.S. Bankruptcy Court. *Id.*

10. A life annuity as "[a]n annuity payable only during the annuitant's lifetime, even if the annuitant dies prematurely." BLACK'S LAW DICTIONARY 89 (7th ed. 1999).

11. Dollar-cost averaging is "the investment practice of purchasing a fixed dollar amount of a type of security at regular intervals." BLACK'S LAW DICTIONARY 499 (7th ed. 1999).

12. See generally Priv. Ltr. Rul. 199943002 (Nov. 10, 1998).

same period, and how they are currently being recaptured by those who believe injury victims should not be forced to rely on an adversary for lifetime financial planning.

First, for background and appreciation of the generous subsidy Congress has provided to injury victims through income tax exclusion, this note will describe the evolution of this device from its simple form in its infancy to today's enhanced and complex version in Section II. The transformation evolved largely from Tax Code<sup>13</sup> changes, product innovations created by the annuity issuers (made with the input of those involved in purveying structured settlements). The concept also benefited from favorable rulings issued by the Internal Revenue Service (IRS) and the judiciary, which will be covered in Section II. This section will also cover the birth of the structure as a legitimate concept, from two revenue rulings in 1979, and their later codification along with the creation of the "qualified assignment."<sup>14</sup> The creation of an exclusive marketing force, designed to restrict entry to full-time brokers dedicated to the defense's cause, will be explored in Section III. That section will also look at the legal challenge mounted by those who desired to work with plaintiffs and their lawyers, during which time the annual premium paid to purchase settlement annuities grew to \$4 billion then stagnated or declined. Section IV will then follow the refinement of structured settlements, tracking product developments and several rule changes and their effect on the economic advantage of the transaction, and including a strong but unsuccessful challenge by

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13. The Tax Code, as it is commonly called by tax professionals, is also known as the Internal Revenue Code or as Title 26 of the United States Tax Code. It is referred to herein as 26 U.S.C. or I.R.C. Similarly, Treasury Regulations, also known as Income Tax Regulations and which appear in the Code of Federal Regulations, are referred to as 26 C.F.R.

14. Rev. 79-220, 1979-2 C.B. 74. Rev. Rul. 79-313, 1979-2 C.B. 75. Most claim resolutions today that include periodic payments are handled in two transactions, occurring consecutively but usually on the same date:

*Settlement Agreement and Release.* This extinguishes the tort liability and damage claims on other theories of recovery, allocates the recovery to determine taxable amounts (for property damage, emotional distress, punitive damages, defamation, interest, etc.) and nontaxable amounts (for personal physical injury or physical sickness, including resulting death, or a workers' compensation claim); specifies the payments to be made at the time of settlement and designates the payee(s); and creates an obligation for future periodic payments (arising only from non-taxable damages), fixing and determining the time and amount of each payment and designating the payee. Thus, from this transaction, the defendant and/or insurer is released from all liabilities under the basic claim, but takes on a new obligation by promising to make future payments.

*Qualified Assignment and Release.* This transaction is between the defendant or its insurer and the third-party assignee that has agreed to accept the liability for the future payments created in the settlement agreement. It is done with the permission of the payee, usually expressed in the settlement agreement and/or in the qualified assignment document. The authority for the "qualified assignment" is 26 U.S.C.A. § 130 (2000). Sometimes, though rarely, the qualified assignment is made without releasing the original defendant or insurer. Often, the qualified assignment includes a pledge agreement that gives the payee a security interest in the annuity contract or Treasury obligation that funds the future payments, in the event the assignee defaults. The money paid to the third-party assignee, which the assignee will use to purchase the "qualified funding asset" should be expressed as consideration to the third-party, not as part of the settlement funds being paid to the claimant. Otherwise, the amount paid to the assignee might be construed by the IRS as part of the settlement amount paid to the claimant, which would constitute "constructive receipt" and result in all future growth of the asset to be a taxable event to the claimant. See *supra* note 4. If section 130 is followed, the money paid to the third party is not taxable. The defendant or its insurer gets to deduct the amount paid to the third party as "economic performance". 26 U.S.C.A. § 461(h) (West 2000).

the IRS to stop attorneys from structuring their contingent fees.

Second, this note will observe a shift in the control of the process, and the inherent advantage that goes with that control, from self-insured defendants or their liability insurer to injury victims. Section V will cover legal malpractice risks plaintiff attorneys encounter by allowing the adversary to control structured settlement transactions, the efforts of plaintiff-advocate settlement brokers to spread the word of those risks, and the successes and failures encountered by those who seek to change the system. Section VI will highlight the emergence of the qualified settlement fund ("QSF")<sup>15</sup> as a means of transferring control of the process from the defense to the injury victim.

Will structured settlements, rejuvenated by the introduction of equity-based variable annuities and an ongoing power shift to plaintiffs and their attorneys, resume the rapid growth pattern of early years? Section VII will look at the future of this very generous tax benefit bestowed by Congress on physically injured victims.

## II. ORIGIN OF THE CONCEPT

The idea that personal injury damages should be excluded from taxable income dates back to the Revenue Act of 1918.<sup>16</sup> Its legislative history indicates a belief that there was no gain associated with compensation for personal injuries or sickness and, therefore, no income within the meaning of the Sixteenth Amendment.<sup>17</sup> There is nothing in the report to suggest that Congress intended the tax exclusion as a sign of compassion for tort injury victims.<sup>18</sup> In a 1922 tax ruling, *Eisner v. Macomber*, the IRS similarly determined that compensatory damages for the invasion of a personal right did not constitute taxable income as gain derived from capital, labor or a combination of both.<sup>19</sup> The Board of Tax Appeals in 1927 used different reasoning than *Eisner* in excluding damages in

15. 26 C.F.R. § 1.468(B) (2000).

16. Revenue Act of 1918, Pub. L. No. 65-254, § 213(b)(6), 40 Stat. 1057, 1066 (1919). This Act provided in pertinent part:

[T]he term "gross income" . . . does not include the following items: . . . [a]mounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness.

*Id.*

17. This amendment, adopted only five years earlier in 1913, reads: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. CONST. amend. XVI.

18. The House Committee on Ways and Means report accompanying the Revenue Bill of 1918 says:

Under the present law it is doubtful whether amounts received through accident or health insurance, or under workmen's compensation acts, as compensation for personal injury or sickness, and damages received on account of such injuries or sickness, are required to be included in gross income. The proposed bill provides that such amounts shall not be included in gross income.

H.R. REP. NO. 65-767, at 4-5 (1918).

19. *Eisner v. Macomber*, 252 U.S. 189, 207 (1920).

*Hawkins v. Commissioner*<sup>20</sup> when it concluded that compensatory damages cannot by definition constitute gain or income, because they are to make the plaintiff whole and, therefore, are not taxable. In 1955 the U.S. Supreme Court broadened the definition of taxable income to include all realized accessions to wealth in *Commissioner v. Glenshaw Glass*.<sup>21</sup> Yet, even with this expansion of the scope of taxable income, Congress has not touched the exclusion of compensatory damages under I.R.C. section 104(a)(2). However, in 1996 Congress specifically lifted the exemption for all punitive damages, even those stemming from a physical injury or sickness.<sup>22</sup>

Congress did not provide its rationale when the exclusion for internal growth of annuities used to fund future payment liabilities was codified under section 104 of the Code in 1982.<sup>23</sup> Yet, the exclusion of compensatory damages for personal injury, including the growth of the funding asset as long as it was not owned by the claimant, was deliberate. Was Congress now demonstrating compassion for injury victims? No one knew for sure. Congress avoided subsequent opportunities to provide its reasoning in 1988,<sup>24</sup> 1996<sup>25</sup> and 1997,<sup>26</sup> when it amended sections 104 and 130, the two key Code sections affecting periodic payments. Neither the statute's language nor the corresponding congressional committee hinted at Congress' reasons for allowing the exclusion from income on growth of the

20. *Compare Hawkins v. Commissioner*, 6 B.T.A. 1023 (1927), *acq.* C.B. VII-1, 14 (1928) and *Eisner*, 252 U.S. 189.

21. *See generally Commissioner v. Glenshaw Glass*, 348 U.S. 426 (1955).

22. The Small Business Protection Act of 1996, §1605(a)-(c). H.R. REP. NO. 104-586 (1996) states:

The bill [H.R. 3448] provides that the exclusion from gross income only applies to damages received on account of a personal physical injury or physical sickness. If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party. For example, damages (other than punitive damages) received by an individual on account of a claim for loss of consortium due to the physical injury or physical sickness of such individuals spouse are excludable from gross income. In addition, damages (other than punitive damages) received on account of a claim of wrongful death continue to be excludable from taxable income as under present law . . . . The bill [H.R. 3448] also specifically provides that emotional distress is not considered a physical injury or physical sickness. Thus, the exclusion from gross income does not apply to any damages received (other than for medical expenses as discussed below) based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress. Because all damages received on account of physical injury or physical sickness are excludable from gross income, the exclusion from gross income applies to any damages received based on a claim of emotional distress that is attributable to a physical injury or physical sickness. In addition, the exclusion from gross income specifically applies to the amount of damages received that is not in excess of the amount paid for medical care attributable to emotional distress.

*Id.*

23. Periodic Payment Settlement Tax Act of 1982, § 101(a). *See also* H.R. REP. NO. 97-832 (1982); S. REP. NO. 97-646 (1982).

24. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 6079, 102 Stat. 3709 (1988).

25. The Small Business Protection Act of 1996, §1605(a)-(c). H.R. REP. NO. 104-586 (1996).

26. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 962(a), 111 Stat. 891 (1997).



funding asset.

Very early, some liability insurers and large self-insured defendants, including the U.S. Government,<sup>27</sup> saw this tax break as a way to achieve savings for themselves. They would negotiate settlements in terms of cash that they were willing to spend. But, if the injury victim wanted to have all or part of that amount applied to future payments, the defense often would insist on spending less than its cash offer, because the tax advantage enhanced the plaintiff's economic recovery. The defense took the position that it too was entitled to a piece of the tax advantage. That philosophy is still employed today by a large number of defendants and liability insurers. This will be discussed further in Section V.

In 1999, Congress belatedly confirmed that its intent all along was to subsidize injury victims through the Internal Revenue Code by excluding from gross income the amount of damages (except punitive) in cases involving personal physical injury or physical sickness.<sup>28</sup> Congress said the tax exclusion is an incentive for that individual or his or her guardian to elect guaranteed future periodic payments rather than a lump sum, which might be dissipated causing the injury victim ultimately to become a ward of society.<sup>29</sup> The term subsidy was used in the text of the Joint Committee on Taxation, Tax Treatment of Structured Settlement Arrangements, March 16, 1999.<sup>30</sup>

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27. Memorandum from Jeffrey Axelrad, Director, Torts Branch, Civil Division, U.S. Department of Justice, to FTCA Staff, Assistant United States Attorneys, and Agency Counsel, (May 10, 2000) (on file with author). He states, "[t]he ability of a tax-free lifetime series of annuity payments, for example, should not be conferred on a plaintiff without an offsetting benefit to the government: that is, an adequate *quid pro quo*. You should be aware of all of the government's interests and take them into account when you negotiate a settlement on behalf of the United States."

In settling a tort claim, the federal government will agree to pay a cash lump sum. But, if the claimant desires tax-free periodic payments, the government takes the position that it must reduce the overall amount it will spend on the settlement to offset the tax benefits to the claimant that will result from the structure. This appears to be in direct conflict with congressional intent as expressed in the Joint Committee on Taxation document, which considers the tax benefit a "subsidy" designed to encourage the injury victim to accept periodic payments. See *infra* note 31.

28. 26 U.S.C. § 104(a)(2).

29. *Id.*

30. The main thrust of this report was to discuss proposed legislation to initiate a tax on the purchase of future settlement payments. But, the purpose of the tax benefit intended by Congress was made clear in the following excerpt:

[I]t can be argued that the choice of the lump sum settlement may create an externality, that is, a cost to taxpayers at large, not borne by the individual who chooses the lump sum settlement. This externality could arise as follows. The amount of damages in a case involving personal physical injuries or physical sickness may be based on the lifetime medical needs of the recipient. If a recipient chooses a lump sum settlement, there is a chance that the individual may, by design or poor luck, mismanage his or her funds so that future medical expenses are not met. If the recipient exhausts his or her funds, the individual may be in the position to receive medical care under Medicaid or in later years under Medicare. That is, the individual may be able to rely on Federally financed medical care in lieu of the medical care that was intended to have been provided by the personal injury award. Such a 'moral hazard' potential may justify a subsidy to encourage the use of a structured settlement arrangement in lieu of a lump sum payment to the recipient, to reduce the probability that such individuals need to make future claims on these government programs. Under the structured settlement arrangement, by contrast to the lump sum, it is argued that because the amount and period of the payments are fixed at the time of the settlement, the payments are more likely to be available in the future to cover anticipated medical expenses . . . .

### A. *Early Revenue Rulings*

While the exclusion of compensatory damages from taxable income dates back to 1918, it took more than sixty years for the idea to develop that the internal growth of an annuity policy purchased to fund future payments should also be exempt as long as the payee did not own the annuity. Originally, the money was paid to the claimant, and the annuity was purchased in the claimant's name. But, the IRS had problems with that concept because the claimant had control over the funds while they grew.<sup>31</sup> Eventually, when annuities were purchased and owned by defendants or their liability insurers, the IRS approved and a new industry was spawned.

Efforts in 1965 to exclude income earned on compensatory damages, after the claimant received the money, were not successful. According to Revenue Ruling 65-29, "[i]ncome realized from the investment of a lump-sum payment representing the discounted present value of a damage award for personal injuries is not excludable from gross income under section 104 of the Internal Revenue Code of 1954."<sup>32</sup> The court awarded the taxpayer disability damages for ten years, but calculated the present value and ordered that sum paid as satisfaction of judgment.<sup>33</sup> The IRS was troubled that the taxpayer had "unfettered control over the lump-sum payment and over the income from the investment of such payment."<sup>34</sup> Only the lump sum and none of the investment income was excluded from the gross income.

In 1972, the IRS ruled that "[a]mounts payable to an employee under a deferred compensation arrangement are not includible in gross income until received or made available where the employee does not acquire a present interest either in the amounts credited or in an employer's annuity contract used as a funding method."<sup>35</sup> This set the stage for annuities to be used to fund future payments to injury claimants as long as the payee had no present interest in the amount used to purchase the annuity or in the annuity itself.

Structured settlements became legitimate in 1979 when the IRS issued two significant rulings. Revenue Ruling 79-220 addressed a scenario where an insurance company purchased and retained exclusive ownership in a single premium annuity contract to fund monthly payments stipulated in settlement of a damage suit.<sup>36</sup> The issue was whether the exclusion from gross income provided for under section 104(a)(2) of the Internal Revenue Code of 1954 applied to the full amount of each monthly payment or only to its discounted present value.<sup>37</sup> In Revenue Ruling 79-220, the IRS ruled that the full amount was excluded and that

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STAFF OF JOINT COMM. ON TAXATION, 106TH CONG., TAX TREATMENT OF STRUCTURED SETTLEMENT ARRANGEMENTS (Comm. Print 1999) (footnote omitted).

31. Rev. Rul. 65-29, 1965-1 C.B. 59.

32. *Id.*

33. *Id.*

34. *Id.*

35. Rev. Rul. 72-25, 1972-1 C.B. 127.

36. Rev. Rul. 79-220, 1979-2 C.B. 74.

37. *Id.*

payments made to the estate after the recipient's death also would be fully excludable.<sup>38</sup> Revenue Ruling 79-313 considered whether a taxpayer receiving payments for personal injury in settlement with an insurance company as a result of an accident would receive the exclusion.<sup>39</sup> The insurance company had agreed to make fifty consecutive annual payments, each of which would be increased by five percent a year.<sup>40</sup> The entire amount received the exclusion.<sup>41</sup>

It was during this time that liability insurers decided to maintain a list of approved life insurance companies from which annuities would be purchased.<sup>42</sup> After all, if the annuity issuer became insolvent, the liability insurer was still liable for payments to the claimant. The annuity was only the funding asset and the annuitant was only a general creditor of the liability insurer.

### *B. Periodic Payment Settlement Tax Act of 1982*

Liability insurers that offered structured settlements in resolving personal injury claims were paying out large sums of money to purchase annuities, but were not able to take the tax deduction or lower their reserves because the annuities were assets of the insurers, not the claimants. Tax deductions could be taken only for the amounts paid to the claimants from the annuities and only in the years in which the payments were made. The liability for the future payments was also to be reflected in the reserves. To make the structured settlement more attractive to liability insurers, a brokerage group engaged the services of David M. Higgins, a tax attorney in Los Angeles, to help persuade Congress to amend the Tax Code to allow the future payment obligation to be transferred to a third party.<sup>43</sup> To make this work, the liability insurer needed to get the tax deduction for the whole annuity premium in the year it was paid. And, the party assuming the future payment obligation could not incur a tax liability for receiving the premium amount from the liability insurer. The transaction had to be tax neutral to the assignee.

Higgins was successful in working with the IRS to draft legislation. He also enlisted the support of the Congressional Budget Office, which reported to the House Committee on Ways and Means: "This bill does not provide for any new budget authority or any new or increased tax expenditures. . . . [we estimate] that the bill will have a negligible effect on budget receipts."<sup>44</sup> The result was the Periodic Payment Settlement Tax Act of 1982 ("Act of 1982").<sup>45</sup> The Act of 1982

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38. Rev. Rul. 79-220, 1979-2 C.B. 74.

39. Rev. Rul. 79-313, 1979-2 C.B. 75.

40. *Id.*

41. Rev. Rul. 79-313, 1979-2 C.B. 75.

42. See generally Jack L. Meligan, *Using Plaintiff Structured Settlement Specialists*, TRIAL MAG., Apr. 1999, at 76.

43. Interview with David Higgins, Esq., in Wash., D.C. (Aug. 19, 1999) (notes on file with author). This commentator is personally acquainted with David M. Higgins and has spoken to him several times about the history of the Periodic Payment Settlement Act of 1982.

44. H.R. REP. NO. 97-832 (1982). The Congressional Budget Office report was signed by Raymond Scheppach for Alice M. Rivlin, Director.

45. Periodic Payment Settlement Act of 1982, § 104.

codified Revenue Rulings 79-220 and 79-331 in section 104(a)(2) and inserted a new section 130 into the Code. Section 130 was to provide that, “under certain circumstances, any amount received for agreeing to undertake an assignment of a liability to make periodic payments as personal injury damages is not included in gross income,” according to the House committee report.<sup>46</sup>

Specifically, any amount so received will not be included in gross income to the extent it is used to purchase an annuity or an obligation of the United States if the annuity or obligation is designated (under regulations prescribed by the [Treasury] Secretary) to fund the periodic payments and the purchase is made within 60 days before or after the date of the assignment.<sup>47</sup>

By executing a “qualified assignment” prescribed in section 130, the original defendant or liability insurer that agreed to make the future payments to the plaintiff can be relieved of its responsibility and receive a tax deduction for the amount paid to purchase the annuity or government obligation. Prior to 1983, the defendant or its liability insurer owned the funding asset. The plaintiff was merely a general creditor of the obligor. If the obligor became insolvent, the plaintiff stood in line with all other general creditors to be paid from whatever assets existed, including the annuity the obligor had purchased.

The obligor was not allowed a tax deduction on the annuity’s cost because the annuity was simply another form of asset rather than the cash. A tax deduction could be taken only when payments were made to the plaintiff and for the years in which the payments were made. From the plaintiff’s perspective, he or she remained beholden to the defendant or liability insurer to receive the future payments.

With section 130, the liability to make future payments can be transferred as a novation to a third party new to the case. A novation substitutes a new party and discharges one of the original parties to a contract by agreement of all parties.<sup>48</sup> The novation is called a “qualified assignment” under section 130.<sup>49</sup> Not only is the original defendant’s tort liability extinguished, so too is the liability to make the future payments promised in the settlement agreement. The third party is usually affiliated with the annuity issuer. Once the assignee accepts the future payment obligation, the original obligor is relieved of liability and gets to take a current year tax deduction for the whole amount it paid for the settlement, including any

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46. H.R. REP. NO. 97-832 at 4.

47. 26 U.S.C. § 130 (1983). This section of the Code, inserted by the Periodic Payment Settlement Tax Act of 1982, permits the amount of money used to purchase an annuity or government obligation to fund payments of a settlement agreement for a personal injury suit to be excluded from the assignee’s gross income. *Id.* Initially, section 130 permitted qualified assignments from only claims excluded under I.R.C. § 104(a)(2). Later, the Taxpayer Relief Act (formerly called the Balanced Budget Act) of 1997 added workers’ compensation payments under I.R.C. § 104(a)(1) to the language of I.R.C. § 130, making them eligible for qualified assignment the same as physical injury or physical sickness tort claim payments under I.R.C. § 104(a)(2), but applicable to claims under workmen’s compensation acts filed after the date of the enactment of the Taxpayer Relief Act (August 5, 1997).

48. RESTATEMENT (SECOND) OF CONTRACTS § 280 (1981).

49. 26 U.S.C.A. § 130(c) (West 2000).

cash at the time of settlement and the annuity's purchase price.<sup>50</sup> The third-party assignee has no income tax liability for accepting the payment with which to purchase the annuity, as long as the payment does not exceed the aggregate cost of any funding assets. If the liability insurer at one time was justified in maintaining a list of "approved" life insurance companies, such a list was no longer justified. Not only is the liability insurer's tort liability extinguished, so too is its future payment liability.

The Act of 1982 also added after the phrase "whether by suit or agreement" the words "and whether as lump sums or as periodic payments," for tax years ending after 1982.<sup>51</sup> This codified the 1979 revenue rulings. Both the House and Senate committee reports<sup>52</sup> reasoned "it would be helpful to taxpayers to provide statutory certainty in the area."<sup>53</sup>

### C. *The Periodic Payment of Judgments Acts of 1980 and 1990*

The National Conference of Commissioners on Uniform State Laws (Conference) responded quickly to the 1979 revenue rulings by adopting the Model Periodic Payment of Judgments Act of 1980 ("1980 Act").<sup>54</sup> The Conference recognized that the common law system of awarding damages in bodily injury cases is of lump-sum payment. "The trier of fact must determine at the time of trial all damages, past and future, that are owing to a claimant." The group also noted that very large awards had become common and no longer the exception.<sup>55</sup> The Conference encouraged states to require payments for future economic damages in bodily injury cases to be made as the damages occur.<sup>56</sup>

The Conference, thus, also recognized that the defendants and their liability insurers (mostly the latter) were providing the financial expertise to arrange the future payments. Structured settlements had become a device offered and arranged by the defense. But, it must be noted that this act was written prior to the Act of 1982, which permitted the original party to assign the future payment liability to a third party. In 1980, the original party was required to purchase and own the annuity, if one was purchased. Some defendants or insurers simply funded future payments as they became due, out of their cash flow.

When the 1980 Act was approved, there were already statutes in fourteen states permitting or requiring certain tort awards for future damages to be paid in installments over the time that the losses would accrue. By 1990, more than thirty states had adopted some type of periodic payment legislation, but only South

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50. See generally, Priv. Ltr. Rul. 97-03038.

51. 26 U.S.C.A. § 104(a)(2).

52. H.R. REP. NO. 97-832; S. REP. NO. 97-646 (1982).

53. *Id.* The same quote is found in both reports, both at page 4.

54. BLACK'S LAW DICTIONARY 1019 (7th ed. 1999), defines model act as a "[s]tatute drafted by the National Conference of Commissioners on Uniform State Laws and proposed as guideline legislation for the states to borrow from or adapt to suit their individual needs."

55. UNIFORM PERIODIC PAYMENT OF JUDGMENTS ACT (National Conference of Commissioners on Uniform State Laws 1990).

56. *Id.*

Dakota had adopted the model act, though limiting it to medical malpractice cases.<sup>57</sup> The Conference tried again to come up with a model that would be attractive to state legislatures, adopting the Uniform Periodic Payment of Judgments Act of 1990 ("1990 Act")<sup>58</sup> which was approved by the American Bar Association on February 12, 1991. Still, no states have adopted the mandatory periodic payments act.<sup>59</sup>

However, the 1990 Act provided plaintiff attorneys a standard for applying due diligence in accepting an annuity issuer. The 1990 Act would have directed state insurance commissioners to publish a list of insurers designated as qualified to participate in the funding of periodic payment judgments. While some commissioners have voluntarily maintained such lists, the standards imposed by the model are standards any attorney can follow. The 1990 Act lists minimum standards that, *inter alia*, the company must have. They include "a minimum of \$100,000,000 of capital and surplus, exclusive of any mandatory security valuation reserve" and at least two of the following minimum or better ratings from independent analysts: A.M. Best Company, A+; Moody's Investors Service Claims Paying Rating, Aa3; Standard & Poor's Corporation Insurer Claims Paying Ability Rating, AA-; Duff & Phelps<sup>60</sup> Credit Rating Company Insurance Company Claims Paying Ability Rating, AA-; or a "rating equivalent to those listed from any other nationally recognized rating organization."<sup>61</sup>

### III. DEVELOPMENT OF A \$4 BILLION ANNUAL INDUSTRY<sup>62</sup>

Following the 1979 revenue rulings that allowed tax-free benefits from an annuity, life insurance companies responded to this new sales opportunity by developing flexible single-premium immediate annuities to meet a recipient's long-term needs. For example, the first payment could be deferred for several years if a minor would not need the money until adulthood. To keep pace with inflation, payments could be set to increase by a fixed rate that is compounded annually. In the early 1980s, annuities were considered perfect for funding periodic payments because they offered double-digit internal rates of return. Until

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57. *Id.* at Prefatory Note.

58. *See* 1990 Act, *supra* note 55.

59. *Id.*

60. *Id.* Duff & Phelps became Fitch in 2000.

61. *Id.* at § 18.

62. Statistics on structured settlement annuity sales are kept informally within the industry, probably by the National Structured Settlements Trade Association ("NSSTA") for assessing dues to life insurance company members based on their individual sales, but not released to the public. Not all liability insurers and life insurance companies that issue annuities for periodic payments are members of the NSSTA. Therefore, the information collected by NSSTA is incomplete. It is generally believed that structured settlements began in about 1976, when annuities were brokered to liability insurers as a means of reserving funds to make future payments, relieving the liability insurer of the administrative task of sending out the checks. The growth peaked in 1991 at \$4 billion in annuity sales that year, not counting in-house sales between affiliated liability insurers and life insurance companies, then dropped to \$3.6 billion in 1992 before bouncing back to \$4 billion in 1993. DANIEL W. HINDERT ET. AL, STRUCTURED SETTLEMENTS AND PERIODIC PAYMENT JUDGMENTS, § 1.03 (Pub-Law Journals Seminary-Press, Rel. 16 1994).

the Tax Reform Act of 1986, many taxpayers were in marginal combined federal and state income tax brackets exceeding fifty percent. With a structured settlement, the injury victim received an excellent rate of return guaranteed for the life of the annuity. The victim also avoided paying income taxes not only on the initial amount paid to purchase the annuity but on all the growth as well.<sup>63</sup>

Structured settlement annuity sales grew rapidly to about \$4 billion by 1991.<sup>64</sup> However, sales declined to \$3.3 billion in 1998<sup>65</sup>, despite soaring damage awards and record settlements. Many observers suspect lower interest rates since the double-digit days of the early 1980s have made the prospect of higher returns in taxable investments an attractive alternative.<sup>66</sup>

#### A. *Annuity Issuers Became Competitive and Made Product Innovations*

To be a competitor in today's structured settlement marketplace, a life insurance company must offer an annuity with all the available features—frequent rate pricing, annual increases in payout, deferred lump sums, commutation to a lump sum upon death, and rated ages based on impaired life expectancy of the annuitant. It must also offer an assignment entity to accept the future payment obligation from the defendant or its insurer, and strong ratings from the independent analysts.<sup>67</sup> These requirements have resulted in the product innovations that have improved structured settlements over the years.

Some twenty-five highly-rated life insurance companies are competing today for the premium dollars spent annually by liability insurers and self-insured corporations to purchase annuities that are used to indemnify physical injury accident victims and workers' compensation claimants. To be successful in the structured settlement marketplace, insurers and brokers need to offer innovative product features and, unlike most conventional fixed annuity products, daily rate pricing. They must also understand the rationale for the business and its enabling legislation, history and current needs. Most companies offering structured

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63. Richard B. Risk, *Annuity Companies Vie for Structured Settlements*, NATIONAL UNDERWRITER, LIFE & HEALTH/FINANCIAL SERVICES EDITION, July 13, 1998, at 30.

64. HINDERT, *supra* note 63. See also *infra* note 66.

65. E-mail Eric Sondergeld, Assistant Vice President, Life Insurance Marketing Research Association (LIMRA) International to Richard B. Risk (Nov. 22, 2000) (on file with author) [hereinafter LIMRA]. LIMRA's estimated sales for 1993 was \$2.8 billion, as compared with Hindert's estimate of \$4 billion. HINDERT, *supra* note 63. The Hindert figures, which run from 1975 through 1993, are based on an estimate of Michael Bodtker, Vice President, First Colony Life Insurance Co. Post-1985 estimates are based on Hindert's conversation "with various life companies participating in the structured settlement industry." *Id.* LIMRA estimated that sales hit \$4 billion in 1999. LIMRA bases its figures on reports submitted to it by life insurance companies that issue annuities as structured settlement funding assets. However, the list may not be all-inclusive of the industry. The LIMRA figures run from 1993 through 1999. Sales figures (in billions) according to Hindert, by year, are: 1975 (0), 1976 (.005), 1977 (.015), 1978 (.040), 1979 (.150), 1980 (.350), 1981 (.575), 1982 (.9), 1983 (1.3), 1984 (2.0), 1985 (2.5), 1986 (2.9), 1987 (3.3), 1988 (3.6), 1989 (3.75), 1990 (3.9), 1991 (4.0), 1992 (3.6), 1993 (4.0). HINDERT, *supra* note 63. Sales figures (in billions) according to LIMRA, by year, with only 1993 reported in common, are: 1993 (2.8), 1994 (3.0), 1995 (n/a), 1996 (3.1), 1997 (2.7), 1998 (3.3), 1999 (4.0). Cf. LIMRA e-mail and HINDERT, *supra* note 63.

66. Risk, *supra* note 64.

67. *Id.* at 29-30.

settlement annuities restrict the selling of these products to about forty independent brokerage firms and in-house operations of some liability insurers specializing in this area. Most likely this is because tort claim settlements are always between adversarial parties and because the annuity products and settlement documents that accompany annuity sales are more complex than the traditional fixed annuity. Annuity companies prefer having their products handled by experienced agents who are comfortable working with attorneys from both sides in this adversarial environment and drafting the settlement documents to conform with tax laws.<sup>68</sup> Often, career “captive” agents of major life insurance companies are restricted from marketing those companies’ structured settlement annuities. Nationally, there are about 430 full-time structured settlement brokers.<sup>69</sup>

### *B. Alliances Formed Between Brokerages and Liability Insurers*

Since 1979, most property and casualty insurers have formed alliances with structured settlement brokerages to use structured settlements as a tool for the defense.<sup>70</sup> Thus, the broker handles all or at least several of the liability company’s claim files, working with the adjuster. Often, this arrangement with the liability insurer includes a sharing of the commission from the annuity sale with the defendant or insurer. As a reward to the defense broker, the insurers have developed approved broker lists, designed to exclude plaintiff brokers from receiving any of the commission for the valuable service they provide to injury victims.<sup>71</sup>

Under the original concept, when the defendant or insurer purchased the annuity as the funding asset underlying the future payments, the defendant or its insurer remained liable to make the future payments in the event the annuity company defaulted. That gave rise and justification to the development of an “approved list” of annuity markets. However, since the addition of the Periodic Payment Settlement Act of 1982<sup>72</sup> most structured settlements involve a “qualified assignment” of the periodic payment obligation releasing the defendant and its insurer from all future payment liability.<sup>73</sup> Yet, they still insist on excluding certain markets, mostly for political reasons.<sup>74</sup>

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68. *Id.* at 29.

69. 1999-2000 Membership Directory, Nat’l Structured Settlements Trade Ass’n (NSSTA).

70. See generally Jay A. Urban & Ronald J. Endter, *Structured Settlements By the People, For the People: Time for Plaintiffs to Control Their Financial Futures*, 22 THE VERDICT 22-23 (1999), and Richard B. Risk, *Structured Settlements: It’s Time to Take Control Away From the Defense in Structured Settlement Negotiations*, 17 FORUM 72-73 (1999).

71. *Id.*

72. 26 U.S.C.A. § 130.

73. See generally Risk, *supra* note 71.

74. For example, Security Life of Denver Insurance Company, part of the huge global International Nederlanden Groep (ING) and with impeccable credentials, was literally driven out of the structured settlement marketplace because it adopted policies that were supportive of brokers who worked exclusively with plaintiffs. Some of the larger brokerages which were on the “approved list” of liability insurance companies boycotted Security Life of Denver, and many of the liability insurers would not put the company on their list of “approved life markets.” Security Life of Denver stopped accepting



### C. *Creation of Trade Organization to Protect the "Haves"*

The National Structured Settlements Trade Association ("NSSTA") was formed in 1984 to advance the use of structured settlements as a means of using periodic payments to resolve personal injury claims, workers compensation, and other types of claims.<sup>75</sup> NSSTA's 1999-2000 membership directory shows the organization to have some 430 members, in the categories of: 1) producer member companies; 2) provider member companies; 3) user member companies; 4) associate members; and 5) honorary members.<sup>76</sup> Producer members are the annuity sales brokerages. Provider members are the life insurance companies that have developed products and services to compete in the structured settlement marketplace. User members are liability insurance companies that actively promote the use of structured settlements in resolving bodily injury tort claims, often with "in-house brokerages." Professional members transcend the first three organizational categories, comprising the employees and others affiliated with the organizational members. Professional members do not vote individually. The approximately 430 individual brokers are included among NSSTA's non-voting members.<sup>77</sup> Associate members are individuals who are not eligible to be professional members, but who have a "legitimate interest" in the business of NSSTA. Currently, associate membership consists only of attorneys who specialize in tax and estate planning matters. Honorary membership is conferred by the NSSTA board and is very rare.

While NSSTA purports to represent the whole structured settlement industry, it does not include a separate voting membership category for those who

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structured settlement business effective September 1, 2000. It had announced in a memo to brokers dated April 21, 2000, that the decision to exit was "as a result of market pressures." Security Life of Denver had entered the marketplace in November 1997. Memorandum from Charles LeDoyen, ING Settlement Solutions, to Richard B. Risk (Apr. 21, 2000) (on file with author).

75. The bylaws of the National Structured Settlements Trade Association ("NSSTA"), at Article I., state:

3. The mission of the Association shall be:

- a) to provide members and others with opportunities for dialogue, education, advancement and self-improvement with respect to the payment of compensation on account of personal injuries and other claims utilizing periodic payments, through meetings, seminars, communications, publication, and any other appropriate programs and activities;
- b) to articulate and advocate the needs and interests of its members and of recipients of compensation paid on account of personal injuries and other claims utilizing periodic payments before legislative, administrative, regulatory and judicial branches of local, state and national government;
- c) to preserve and enhance the role of the structured settlement specialist in the promotion and marketing of the periodic payments concept as a means of claim settlement; and
- d) to promote cooperation between its members and recipients of compensation paid on account of personal injuries and other claims utilizing periodic payments, the legal profession, life and casualty insurers, self-insurers, and other, both directly and through other associations in matters involving the business and governmental affairs of the Association.

NSSTA BYLAWS art. I (1984).

76. NSSTA, NSSTA Membership Directory (1999-2000).

77. *Id.*

work on behalf of plaintiffs, such as trial attorneys and individual brokers who advocate plaintiffs' rights to select an annuity company and a broker to handle the periodic payment transaction. Plaintiff brokers are lumped with defense brokers, who comprise the majority.<sup>78</sup> Although its mission statement<sup>79</sup> does not overtly exclude plaintiff advocates, NSSTA was organized by those who wanted to preserve the structured settlement concept as a defense tool, as evidenced by its membership makeup.<sup>80</sup> In 1988, at its annual meeting held in San Diego, California, NSSTA adopted a resolution called Business Practice and Standards mandating that plaintiff brokers could receive only fees for service from their plaintiff clients, not from annuity sales commissions. A floor amendment was added that postponed the effective date until NSSTA's counsel determined that such a measure did not violate restraint of trade rules.<sup>81</sup> Cite to E-mail, fn 68. Evidently, counsel determined such an infringement because the measure never became effective.<sup>82</sup>

NSSTA also confirmed its defense leanings in 1999 by working to defeat proposed legislation in Florida and New Hampshire that would have given injury victims the right to select their broker, and the right to select the funding vehicle. The Florida initiative (an amendment to S.B. 374) was withdrawn by its proponents as unacceptable after a Florida legislative staff member made changes to the text.<sup>83</sup> The NSSTA board sent its executive vice president to testify before the New Hampshire Senate Commerce Committee in opposition to H.B. 470. The board said in a memorandum dated March 21, 1999, to NSSTA member companies: "The NSSTA takes no position on the question of the market orientation of its members. . . . We endeavor to represent all those who work to accomplish that goal regardless of how they market that service."<sup>84</sup> The memo also said: "We believe that if either party of a settlement negotiation were at a disadvantage, fewer structured settlements would result."<sup>85</sup> Ironically, that last statement rings true, but not in the way it was intended. The majority of structured settlements are handled still by defense brokers because the plaintiffs are at a disadvantage in attempting to exercise control. Critics conjure the number of structured settlements will never reach full potential so long as the plaintiffs' disadvantage remains, but would if that disadvantage were removed.<sup>86</sup>

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78. *Id.*

79. NSSTA BYLAWS art. I (1984).

80. NSSTA BYLAWS art. I (1984).

81. Email from David Snyder, President, Delta Group of Settlement Companies and member, NSSTA to Richard B. Risk (Jan. 1, 1999) (on file with author).

82. *Id.*

83. Memorandum from Charles LeDoyen, ING Structured Settlements, to ING's company's licensed brokers (Mar. 29, 2000) (on file with author).

84. Memorandum from National Structured Settlements Trade Association (NSSTA) Board of Directors, to NSSTA Member Companies (Mar. 21, 1999).

85. *Id.*

86. LeDoyen, *supra* note 84.

#### D. *Creating Barriers to Entry*

It can also be inferred that NSSTA's other unwritten goal is to create a barrier to entry for others in the insurance and investment fields. The life insurance company members of NSSTA were almost universal in excluding even their career-captive life insurance producers from access to their structured settlement annuity products. Typically, this restriction is justified by the annuity issuers on the basis that structured settlements are of a "highly technical and legally complex nature" and that consultants "must be able to document their legal and technical expertise" in this area.<sup>87</sup> They also restrict the number of brokers they will appoint and require a documented ability to produce a minimum amount of premium.

Initially, the annuity issuing life insurance companies also restricted their appointments to those brokerages (general agencies) that would prohibit their individual agents from working on behalf of injury victims and their attorneys. In 1992, in *Weil Ins. Agency v. Manufacturers Life Ins. Co.*,<sup>88</sup> several plaintiff brokers sued several annuity issuers and defense brokerages in U.S. district court based on their defense-only policy, which denied information on costs of structured settlements to brokers who did business with tort plaintiffs. In upholding a summary judgment for the defendants, the Ninth U.S. Circuit Court of Appeals found that, while exclusion of a competitor may be a prerequisite for finding that a refusal to deal violates antitrust laws, it is not enough to find for antitrust injury.<sup>89</sup> The court said antitrust laws are concerned about injury to competition, not competitors.<sup>90</sup> The appellate court acknowledged the injury that occurs from defense-only brokerage, but said, "Weil's injury does not flow from these competitive harms."<sup>91</sup> The plaintiffs had settled with two of the defendants by the time the appeals court ruling was made. But, the impact of this litigation was

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87. Letter from Delphine Evans, Associate, Capital Initiatives (Apr. 9, 1990) (on file with the author). Typical of the annuity market policy is the text of this letter from Capital Initiatives which has been absorbed by AEGON Financial Services, Louisville, Ky., which says in part:

Due to the highly technical and legally complex nature of the structured settlement business, consultants must be able to document their legal and technical expertise in the area of structured settlements. One of the ways Capital Initiatives ensures this expertise is by restricting our licensing to companies that specialize in doing primarily structured settlement business. This approach is designed to avoid unduly exposing Capital Initiatives to the many and significant liabilities associated with the structured settlement business.

In order to ensure that Capital Initiatives provides superior service to our structured settlement consultants, we limit the number of consultants we license. . . .

In order to meet our aggressive production goals and to ensure a mutually beneficial relationship, prospective consultants must be able to document the ability to produce at least \$2.5-3.0 million in annual premium with Capital Initiatives.

*Id.*

88. *Weil Ins. Agency v. Mfrs. Life Ins. Co.*, 815 F.Supp. 1320 (N.D. Cal. 1992), *aff'd sub nom.* *Legal Econ. Evaluations, Inc. v. Metro. Life Ins. Co.*, 39 F.3d 951 (9th Cir. 1994).

89. *Legal Econ. Evaluations*, 39 F.3d 951.

90. *Id.* at 953.

91. *Id.* at 955.

positive in that it influenced the life insurance markets to remove their restrictions against doing business with plaintiffs.

*E. The Gray Market "Red Herring"*

During the late 1990s, an industry called "factoring" that had its beginnings by purchasing future payments from lottery winnings at a discount found a new market in structured settlement payment recipients themselves.<sup>92</sup> These factoring companies, sometimes referred to as the "gray market," were deeply criticized by structured settlement brokers, annuity issuers and plaintiff attorneys alike for two main reasons. Critics of payment purchases contended that the transaction goes against one of the structured settlement's primary purposes, to guard against squandering of the settlement funds by the injury victim. Other complaints centered on the discount rate charged by some companies, which critics said was usurious.<sup>93</sup>

Critics claimed there was uncertainty as to how the IRS would treat the settlement purchases, claiming that these transactions could have an adverse impact on the claimant and possibly the liability insurers. A Private Ruling issued by the IRS on June 10, 1999,<sup>94</sup> said that the lump sum payment received by a claimant from a factoring company constitutes damages received on account of personal injuries or sickness and, thus, there is no tax effect. The ruling did not address the question of whether the assignee would be affected, since the ruling was directed only to the taxpayer who requested it.

NSSTA led the effort to oppose settlement purchases, finding sympathetic ears among the Treasury Department and the congressional Joint Committee on Taxation.<sup>95</sup> The Fiscal Year 1999 budget proposed to Congress contained a twenty percent excise tax to the factoring company on any payment purchase deal that did not have court approval.<sup>96</sup> The Joint Committee on Taxation increased its recommendation to fifty percent of the purchase amount,<sup>97</sup> and the House Ways and Means Committee first sponsored a resolution called the Structured Settlement Protection Act of 1998.<sup>98</sup> This measure failed to be attached to any piece of tax legislation, not only in 1998, but in 1999 as well.<sup>99</sup> The NSSTA initiative was reintroduced in 2000, again with little prospect of becoming law. Some speculated correctly, apparently, that such a measure would be viewed more

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92. See generally Margaret Mannix, *Settling for less: Should accident victims sell their monthly payouts?* Margaret Mannix, U.S. NEWS & WORLD REP., Jan. 25, 1999, at 62.

93. See generally STAFF OF THE JOINT COMM. ON TAXATION, 106<sup>th</sup> CONG., TAX TREATMENT OF SETTLEMENT STRUCTURES (COMM. PRINT 1999).

94. See generally Priv. Ltr. Rul. 199273-97 (June 10, 1997).

95. *Id.*

96. U.S. DEPT. OF THE TREASURY, THE GREEN BOOK 122 (U.S. Dept. of the Treasury Feb. 1998). See also Richard B. Risk, *Warning Issued Over Sale of Structured Payments*, MTLA Q., Summer 1998, at 19-20.

97. See STAFF OF JOINT COMM. ON TAXATION (105TH CONG.) REP. ON FED. INCOME TAXATION OF CAPITAL GAINS (Comm. Print 1998).

98. See generally H.R. 4314, 105th Cong. (1998).

99. See generally H.R. 263, 106th Cong. (1999).

as a new tax than as an incentive to prevent settlement purchases without first obtaining court approval as neither passed.

At the same time the efforts to get federal legislation were underway, both NSSTA and the National Association of Settlement Purchasers ("NASP") had their own versions of structured settlement protection legislation that they raced to get passed by various state legislatures before the other side's version could be adopted.<sup>100</sup> NSSTA's total lobbying expenditures increased from \$160,000 during 1997 calendar year to \$280,000 in 1998.<sup>101</sup> This does not include the efforts of its corporate members, primarily the life insurance companies, who also had a different stake in the matter.

Life companies usually were involved in interpleader actions brought by annuity issuers and annuity owners who enter a case involving a payee and a factoring company out of concern that they will be caught in the crossfire of conflicting claims. Life companies and assignees are also sued by payees, alleging that the annuity issuers are standing in the way of a payee's attempt to sell payments to a factoring company by refusing to change the address for sending payments. Other types of litigation arising out of payment purchases include factoring companies litigating against their own customers, usually when a claimant agrees to assign future payments, receives a lump sum from the factoring company, then revokes the assignment. A few class action lawsuits have been filed against the factoring companies alleging violation of usury laws.<sup>102</sup>

The dispute between NSSTA and NASP was resolved on September 13, 2000, when representatives of both organizations signed a letter to the respective chairmen of the U.S. House Ways and Means Committee and the U.S. Senate Finance Committee, transmitting a proposed federal bill that would impose a forty percent excise tax on settlement purchases without first having court approval.<sup>103</sup> Also, certain disclosure requirements to the payee in a federally approved format must be met by the purchasers. Both sides expressed optimism at the bill's early passage. The agreement also included model state legislation for obtaining court approval, since insurance business is regulated by the states.

#### IV. REFINEMENT OF THE CONCEPT

Over the years, through product innovations, tax law changes and rulings by the IRS and judicial decisions, the structure concept has been refined. Claimants now may have the opportunity for holding security interest in the annuity contract without causing loss of tax benefits. (This is discussed in Section VI.) Attorney fee structures have become popular since the IRS lost a major court battle. Widows

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100. See *Case Law*, NSSTA LEGIS. UPDATE, May 1999, at 4.

101. Lobbying expenditures are monitored by The Center for Responsive Politics. Center for Responsive Politics, *Nat'l Structured Settlements Ass'n 1997 Calendar Year*, at [http://www.opensecrets.org/lobbyists/97\\_profiles/17100.htm](http://www.opensecrets.org/lobbyists/97_profiles/17100.htm) (last visited Oct. 1, 2000). Center for Responsive Politics, *Nat'l Structured Settlements Ass'n 1998 Calendar Year*, at [http://www.opensecrets.org/lobbyists/98\\_profiles/17100.htm](http://www.opensecrets.org/lobbyists/98_profiles/17100.htm) (Oct. 1, 2000).

102. See *Case Law*, NSSTA LEGIS. UPDATE, May 1999, at 4.

103. Letter from NSSTA, to Hon. Bill Archer and Hon. William V. Roth, Jr., (Sept. 13, 2000).

and orphans receive the same tax considerations as the decedent would have received. Workers' compensation benefits have been given the same status as tort damages for making a qualified assignment. And, the IRS approved the use of a variable annuity, which invests in equities, as a qualified funding asset for periodic payments.

*A. Attorney Fee Structures Upheld by Appellate Court Over IRS Objection*

The structuring of attorney fees was popular until a few years ago. Then the IRS issued several technical advice memoranda ("TAM"s) which, in effect, were rules internal to the IRS instructing its auditors to disallow these deferred compensation agreements.<sup>104</sup> The IRS levied assessments for income tax deficiencies on three Georgia attorneys who had accepted future payments as part of their compensation from their clients. The attorneys, in *Childs v. Commissioner*,<sup>105</sup> successfully challenged the IRS in Tax Court in late 1994 and prevailed again in 1996 when the IRS appealed to the U.S. Court of Appeals for the Eleventh Circuit.<sup>106</sup> Since that decision, the popularity of attorney fees structures is on the rise, according to reports from the life insurance companies that issue the annuities to fund these deferred payments.<sup>107</sup>

*B. Tax Reform Requires Physical Injury as 'Origin of the Claim'*

Congress amended Tax Code section 104(a)(2) in the Small Business Job Protection Act of 1966<sup>108</sup> to begin taxing punitive damages and damages not attributable to physical injuries or physical sickness. Prior to this act, gross income did not include any damages received, whether by suit or agreement and whether as lump sums or as periodic payments, due to personal injury or sickness. The

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104. Tech. Adv. Mem. 9134004 (May 7, 1991); Tech. Adv. Mem. 9134005 (May 7, 1991); Tech. Adv. Mem. 9134006 (May 7, 1991). A Technical Advice Memorandum ("TAM") is guidance provided to IRS field agents from its headquarters on the IRS' own interpretation of tax law. TAMs are generally not rescinded.

105. *Childs v. Commissioner*, 103 T.C. 634 (1994), *aff'd* 89 F.3d 856 (11th Cir. 1996).

106. *Id.*

107. *Id.* The IRS audited three Georgia attorneys for the year of the settlements and attempted to tax them on the present value of their future payments. In Tax Court, the IRS claimed that the right to receive future payments was funded or secured. If so, tax would be imposed in the settlement year. The Tax Court disagreed with the IRS, saying the right of the attorneys to receive future payments was neither funded nor secured since the attorneys did not own the annuity policies. Tax Court noted that, in one settlement, the assignment company affiliated with the life insurance company issuing the annuity had the right to change the annuitant or beneficiary of each policy without the consent of the annuitant. In the other settlement, the promises by the liability insurer to pay the attorneys in the event the life insurance company issuing the annuity defaulted were not funded. There were also unfunded promises by the parent life insurance corporation to secure the payment obligations of the subsidiary assignment company. *Id.*

The IRS had appealed the Tax Court decision, which held that the cost of the annuity contract funding the structured settlements received by the taxpayers in satisfaction of attorney's fees represented mere "unfunded promises," did not constitute "property" under IRC § 83 and, therefore, was not taxable in the year of purchase. The issue appealed by the IRS was whether the purchase price of the annuities constitutes "property" per IRC § 83 and, if so, whether that "property" was transferred to the taxpayers and subject to taxation during the year of purchase.

108. See Small Business Job Protection Act of 1966, § 1605 (a)-(c).

courts were widely divided on the interpretation of this exclusion, including allowing awards for other than bodily injury or physical sickness and for punitive damages.<sup>109</sup>

The committee report pointed out a claim's origin was the test for determining whether damage payments were excluded from income, regardless of who the payee is.<sup>110</sup> This meant that widows and orphans could receive tax benefits, for example, for wrongful death damage payments resulting from tort injury to the decedent. It also meant that economic damages for lost wages, which would normally be taxed if earned income, would be exempt if due to recovery for a physical injury or physical sickness.<sup>111</sup>

### C. *Workers' Compensation Given Same Status as Physical Injury Tort*

When section 130 was added to the Tax Code in 1982,<sup>112</sup> it provided for the qualified assignment of periodic payments for personal injury within the meaning of section 104(a)(2). It did not include payments for workers' compensation under section 104(a)(1). Through the efforts of NSSTA, Congress added workers' compensation to section 130 as a provision of the Taxpayer Relief Act of 1997, for claims originating after the law's effective date, August 5, 1997.<sup>113</sup> Prior to this Code amendment, a few annuity companies had developed creative means of taking assignment of workers' compensation obligations. One company used the provision of 26 U.S.C. section 72(u) to avoid taxation on the annuity's internal growth.<sup>114</sup> A few others used the concept of a reinsurance contract, which avoided the issuance of an annuity, but was priced the same and produced the same result.<sup>115</sup> The inclusion of section 104(a)(1) payments in section 130, allowing the same traditional qualified assignment as for physical injury tort damage payments, provides statutory certainty to the parties.

### D. *The Approval of the Variable Annuity as a Qualified Funding Asset*

One of the most profound recent developments in structured settlements is IRS approval of a variable annuity in qualified assignments of future payment liabilities. This allows the underlying asset to grow at market rates, rather than at a guaranteed fixed rate set by the life insurance company at the time the annuity is

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109. See generally Richard B. Risk, *Personal Injury Now Must Be Physical to Be Exempt From Income Taxation*, KTLA J., Jan. 1997, at 9.

110. H.REP. NO.104-586 (1996).

111. Risk, *supra* note 111, at 10.

112. Pub. L. 105-34, §962(b), 111 Stat. 892, provides: "The amendments made by subsection (a) [amending subsec. (c) of this section] shall apply to claims under workmen's compensation acts filed after the date of the enactment of this Act."

113. Letter from Legislation and Regulations Committee, NSSTA, to NSSTA Member Companies (Apr. 1997).

114. SAFECO Life Ins. Co., Overview of Non-Qualified Assignments (Apr. 1999) (Settlement Annuities Administrative Manual). SAFECO took assignment of workers' compensation payment obligations through SAFECO National Life Ins. Co. using the exception of 26 U.S.C. § 72(u).

115. The companies using reinsurance agreements included: First Colony Life, Berkshire Hathaway Life, Commercial Union (now CGU) Life, and Monumental Life.

issued. While the variable annuity may not have much application to an injury victim who depends on a predictable payment amount each month, it should have immense appeal to other claimants and plaintiff attorneys who have deferred compensation agreements with their client.

Under a Private Ruling released on October 29, 1999, periodic payments of damages can be "calculated pursuant to an objective formula based on the performance of the Standard & Poor's 500 Stock Index and/or a mutual fund portfolio designed to achieve long-term growth of capital and moderate current income."<sup>116</sup> For the claimant whose financial condition allows tolerance to market fluctuations, a variable annuity can provide the best of both worlds—market growth of the asset, completely free of income tax. As this statement suggests, a variable annuity may not be suited for a plaintiff whose life care and basic necessity requirements are dependent upon a predictable payment amount, which the traditional immediate annuity provides.

## V. RECOGNITION OF THE ETHICAL AND MALPRACTICE RISK PROBLEM

When it comes time to set up lifetime payments for the client for damage recovery, plaintiffs' lawyers routinely have allowed the plaintiffs' adversaries—liability insurance claim adjusters and their structured settlement brokers—to handle what is likely the largest financial transaction in the injury victim's life.<sup>117</sup> Because brokers initially were prevented from working with plaintiffs, it was assumed that brokers could work only for the defense and that the plaintiff had no choice if there were to be future payments excluded from taxable income. That posed a real dilemma for the plaintiffs' attorney. The defense broker certainly had no duty to the plaintiff. Additionally, the defense broker would be released from any future liability, as an agent of the tortfeasor and the insurer. There was no way to tell whether the plaintiff was receiving all benefits promised in the negotiations. Also, no one could be held accountable except the plaintiffs' attorney in the event the documents were flawed, resulting in loss of tax benefits to the plaintiff. Most

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116. Priv. Ltr. Rul. 199943002 (1998). Private Rulings and Technical Advice Memorandums may not be used or cited as precedent, unless the Secretary of the Treasury otherwise establishes by regulations. 26 U.S.C. § 6110(k)(3) (2000). However, the U.S. Supreme Court, in *Hanover Bank v. Commissioner* provides a degree of comfort to taxpayers that private rulings issued by the IRS reflect that agency's interpretation of the statute and, thus, may be used as evidence in litigation of tax matters:

[A]lthough the petitioners are not entitled to rely upon unpublished rulings which were not issued specifically to them, such rulings do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws. And, because the Commissioner ruled, in letter addressed to taxpayers requesting them, that [the action taken by the taxpayer who had requested the private ruling] was proper under the statute, we have further evidence that our construction of [how the Supreme Court ruled in the instant case] is compelled by the language of the statute.

369 U.S. 672, 686-87 (1962).

117. American Bar Association MODEL RULES OF PROFESSIONAL CONDUCT, Rule 1.1., states: "A lawyer shall provide competent representation to the client." Often, the plaintiff's attorney in a physical injury case retains the services of several consultants to aid in trial preparation and to serve as expert witnesses. These consultants all have a duty to the plaintiff. Is it competent representation to allow an adversary to handle the client's lifetime financial plan? MODEL RULES OF PROF'L CONDUCT R. 1.1 (1998).



plaintiffs' attorneys have no expertise in the tax ramifications of the structured settlement transaction.<sup>118</sup>

*A. The Injury Victim is Victimized Again in the Settlement Process*

Because of the advantages traditionally enjoyed by defendants and their liability insurers in the negotiation process, physically injured victims often are victimized a second time, unknowingly to them, when the settlement is made. In the last few years, several articles targeted to plaintiffs' advocates have appeared in publications such as *TRIAL*, the official journal of the Association of Trial Lawyers of America, *Trial Diplomacy Journal* and membership magazines of the various state trial lawyer associations across the country.<sup>119</sup>

As an example of double victimizing, some casualty insurers and their structured settlement brokers do not include the total settlement dollars in the mediation document when an agreement is reached. They ask the claimant to agree to the future payment schedule to be provided by an annuity, without having the annuity cost as part of the record, because they know it is likely that they can purchase the annuity for less than they represented during negotiations. On any given day and for a specific payment scenario, rates between highly rated annuity companies can vary by as much as fifteen percent or more. If the defense broker has not named the annuity company that will be used to fund the future payments, the broker may do the shopping after the parties have agreed on an annuity payment stream, reducing the cost to the defense. If the amount to be spent on the annuity is sizable, some companies will give daily rates that often are cheaper than the published rates, depending on daily security market conditions. The discount is not applied to increase benefits to the claimant, but instead is used to reduce the cost to the defense. If the annuity company raises its rates after the case has settled, the defense can lock in the lower rates and not pay more. But, if the annuity company improves its rates after the case has settled, the defense can capture the savings for itself, representing to the plaintiff that it paid the higher amount.<sup>120</sup>

In other examples of plaintiff victimization, some defense brokers have been known to send the plaintiff's attorney a copy of the check being sent to the annuity company, knowing that the liability insurer will receive a refund of the overpayment. The refund is unbeknownst to the plaintiff's attorney. If the injury victim has a health history, not necessarily limited to the injury or sickness that gave rise to the claim, the life insurance companies may determine that the plaintiff has an impaired life expectancy and will assign a rated age. For an annuity that guarantees lifetime payments, a rated age means a reduced cost for the

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118. Cf. *Is There an Errors and Omissions Exposure In Failing to Offer a Structured Settlement?* Richard B. Risk, *THE ADVOCATE*, Oct.-Dec. 1994, at 22.

119. See generally the following articles: E. Andre Busald et al., *The Case for a Plaintiff Structured Settlement Advocate*, 21 *TRIAL DIPL. J.*, 165 (1998); Meligan, *supra* note 43; Urban & Endter, *supra* note 71; Risk, *supra* note 71.

120. *Id.*

benefits promised at the mediation.<sup>121</sup>

The defense's ability to pay less than it represented during negotiations raises several concerns for plaintiff attorneys. *Black's* defines fraud as "[a] knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment."<sup>122</sup> It would seem that a representation to a claimant by the claims adjuster that a stream of future payments will cost the liability insurer one amount, as consideration for the injury victim to give up the tort claim, but actually costs a lesser amount, constitutes fraud.

### B. Kickbacks Are a Widespread Problem

And if that were not enough, kickbacks are common in the structured settlement industry today.<sup>123</sup> The liability insurer never tells the plaintiff's attorney about this "under-the-table" arrangement with their broker.<sup>124</sup> When there is such an arrangement, the liability insurer expects to receive as much as half of the commission from the annuity sale, which normally would be two percent of the annuity premium.<sup>125</sup> It appears that brokerages who pay kickbacks to liability insurers, not including them in their gross income on their tax returns, run the risk of severe penalties from the IRS, should a court ever determine that such payments are illegal. Section 162(c)(2) of the Code disallows any deduction if the payment constitutes an illegal kickback.<sup>126</sup> Considering that such rebates are thought to be in the millions of dollars each year industry wide, the loss of revenue to the Treasury must be great and the penalties surely would be severe.

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121. See generally Richard B. Risk, *Structured Settlements: Impaired Life Expectancy of Claimant Often Becomes Obstacle to Settlement: Medical Underwriting Can Provide the Solution*, IN BRIEF, Oct. 1997, at 17.

122. BLACK'S LAW DICTIONARY 670 (7th ed. 1999).

123. Letter from Kevin A. Mack, Esq., a former officer of Travelers Property and Casualty Insurance Company, to insurance regulators of Connecticut, Ohio and New York; the attorney general of Connecticut; and the IRS (Feb. 16, 1998) (on file with author). The letter divulged that Travelers had received in excess of \$30 million in rebates over the previous 15 years. *Id.* Mack alleged that Travelers "has been engaged in the practice of demanding and receiving rebates on the sale of annuities in the settlement of their liability and workers' compensation claims since the mid-1980s." *Id.* In addition, Mack said Travelers "has never disclosed the rebates to the claimants, upon which the annuity was purchased; [Travelers'] policyholders, from which the money was taken to pay for the annuity; or its reinsurers, to which [Travelers] misrepresented as to the value of the settlement." *Id.*

124. The National Structured Settlements Trade Association (NSSTA), *Statement of Ethics and Professional Responsibility* (May 1997). It states under Principle III: "Fairness mandates intellectual honesty and disclosure of relevant conflict(s) of interest." *Id.*

125. See Mack letter, *supra* note 123.

126. 26 U.S.C.A. § 162(c)(2) (West 2000) says in pertinent part:

No deduction shall be allowed...for any payment...made, directly or indirectly, to any person, if the payment constitutes an illegal bribe, illegal kickback, or other illegal payment under any law of the United States, or under any law of a State (but only if such State law is generally enforced), which subjects the payor to a criminal penalty or the loss of license or privilege to engage in a trade or business. For purposes of this paragraph, a kickback includes a payment in consideration of the referral of a client, patient, or customer.

*C. Document Errors by Adversaries Having No Duty to Claimant*

Historically, plaintiffs' attorneys rely on the broker to draft the documents using specimen forms that are used commonly in the industry. Because each case is different and there are often elements of a particular case that warrant special consideration, drafting the final documents can be critical. For example, if punitive damages were alleged in the pleadings or even in settlement discussions and the settlement agreement is silent on whether any portion of the payments constitute punitive damages, the IRS has been known to allocate a portion of the settlement to taxable damages.<sup>127</sup> Other common mistakes in settlement documents include the use of archaic language that does not track with current statutes; failure to provide adequate liquidity for estate taxes; unnecessary forfeiture of Medicaid and Supplemental Security Income benefits; and improper reference to the settlement cost as the consideration, which can trigger constructive receipt and loss of future tax exclusion. A broker engaged by the plaintiff's adversary arguably does not have a duty to the plaintiff, and that certainly would be used as a defense in the event of the broker's negligence. The broker would have the additional defense of being released as an agent of the tortfeasor or its insurer. The plaintiffs' attorney indeed has a significant exposure to a legal malpractice claim by the client.

*D. Defense Arguments for Maintaining Control*

All or at least most of the reasons liability insurers desire to maintain control of the structured settlement transaction are adverse to the injury victim. However, there are two arguments used by the defense for handling the transaction, which once might have had faint validity. First, the liability insurers point out that the uniform qualified assignment form has a reversionary clause that would void the novation of the future payment obligation making them owners of the "qualified funding asset" if the settlement agreement were terminated by a court of law or in the event section 130(c) of the Code has not been satisfied.<sup>128</sup> Second, they contend that they might incur a liability to guarantee any future payments promised in the terms of the settlement agreement in the event the assignee defaults, notwithstanding that the claimant has waived any rights to recourse against the assignee, acknowledging that he or she may look only to the assignee for these payments.<sup>129</sup>

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127. See generally *Barnes v. Commissioner*, 73 T.C.M. (CCH) 754 (1997). Punitive damages had been mentioned in the pleadings and the plaintiff's attorney also referred in the negotiations to the "likelihood" of there being punitive damages. *Id.* The settlement agreement did not include any specific allocation of damages. The IRS allocated half of the damages to taxable punitive damages, the remaining half to excludable personal injury damages. *Id.*

128. Nat'l Structured Settlement Trade Ass'n, Uniform Qualified Assignment and Release Form, para. 9 (Apr. 1988) (on file with author). Paragraph 9 of the Uniform Qualified Assignment and Release form adopted in 1988 by NSSTA states: "In the event the Settlement Agreement is declared terminated by a court of law or in the event that Section 130(c) of the Code has not been satisfied, this Agreement shall terminate. The Assignee shall then assign ownership of any 'qualified funding asset' purchased hereunder to Assignor, and Assignee's liability for the Periodic Payments shall terminate."

129. *Id.* at para. 11 reads: "The Claimant hereby accepts Assignee's assumption of all liability for the Periodic Payments and hereby releases the Assignor from all liability for the Periodic Payments."

In the first instance, the right of the claimant to receive payments is terminated if a court voids the settlement. The assignor is made whole, either by being given ownership of the annuity or, more likely, by a refund of its premium outlay less deductions for any payments already made to the claimant. If section 130(c) has not been satisfied, the reason will likely be that damages were not for personal physical injury or physical sickness (except punitive) and, thus, did not qualify for exclusion from current income under section 104(a)(1) or (2), which is a prerequisite for assignment under section 130.<sup>130</sup> Prior to entering into the settlement, the assignor no doubt is aware of the nature of the claimant's injuries, so IRS action to disallow the qualified assignment is highly unlikely. But, assuming that the IRS voided the effect of the qualified assignment, the assignor still would have the means to satisfy the future payment obligation, since it would own the annuity. Most likely, in that event, the annuity ownership would be transferred to the claimant in satisfaction of all future payments since there would no longer be a reason to avoid constructive receipt. The claimant would then have the option to liquidate the annuity if permitted under the terms of the annuity policy or otherwise allowed by the annuity issuer.

In the second instance, if the assignee defaults, there are usually secondary guarantees by the annuity issuer, a surety bond issuer or other guarantor. Assuming the primary and secondary obligors all fail to meet their obligations—an unlikely event—the assignor is still protected by the terms of the qualified assignment contract. The claimant has contractually given up all rights to look to the assignor for any future payment.<sup>131</sup> It would seem, however, that the defense's argument to select the assignee and annuity issuer fails, because any liability that might be incurred due to the default of the assignee or failure of the annuity issuer is greater if the assignor makes the selection rather than the claimant. Conversely, if the claimant makes the selection, there is an assumption of the risk. This makes the argument that the assignor would be better advised to allow the claimant to select the annuity issuer and its related assignment company as well as the broker to handle the transaction.

As explained in Section VI, the QSF renders moot any legitimate objection that can be raised by the liability insurer. The use of the QSF is a two-step process. The liability is stripped from the original parties in the first step, and the tortfeasor is dismissed with prejudice. The future payment obligation and qualified assignment are not created until the second step, which does not involve the tortfeasor or liability insurer as a party.

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130. 26 U.S.C.A. § 130(c) (West 2000). See note 48.

131. *Howard v. Okla. Gas & Elec.*, No. 94564 (Okla. Ct. App. June 23, 2000). This was an unpublished opinion of the Court of Appeals of Oklahoma, the appellee was receiving periodic payments from a structured settlement until the assignee, First Executive, defaulted due to the insolvency of the annuity issuer, Executive Life of California. *Id.* The payments had been reduced by 9% from the terms of the settlement. *Id.* Rejecting the alleged breach of the settlement, the court held that the assignor was not liable for making up the difference. *Id.* The appellee had executed a qualified assignment which transferred the future payment obligation from OG&E to First Executive. *Id.*

## VI. SINGLE-CLAIMANT QUALIFIED SETTLEMENT FUND COMES OF AGE

Plaintiff attorneys have long known that structured settlements were intended by Congress to benefit their clients, the injury victims. Yet, they knew the defense had refined the structured settlement as a tactic to be used against injury victims in negotiating settlements, but did not know what, if anything, could be done about it. Now, plaintiffs can take control of the structured settlement process through a QSF and leave the defense out of the picture once the money has been paid into the fund.

A. *The Black Letter of Treasury Regulations is Disputed by Opponents of the QSF*

The authority for the QSF is set out in the Internal Revenue Code,<sup>132</sup> Treasury Regulations<sup>133</sup> and in a Revenue Procedure.<sup>134</sup> However, the defense attorneys want plaintiffs and their attorneys to believe they cannot use a QSF cases involving a single claimant, because it would deprive them of an uneven bargaining advantage that they have enjoyed for so long. Use of QSF would also deprive the defense structured settlement brokers of the ability to show up at a settlement conference, telling the plaintiff, "I have been assigned to this case," when the plaintiff has every right to select the person to handle the structured settlement transaction on his or her behalf. Most physical injury claims involve a single victim. Thus, attacking the validity of the single-claimant QSF is viewed as a means of maintaining control by the defense.

Because of the language in the Tax Code specifies that the assignee assumes the future payment liability "from a person who is a party to the suit or agreement,"<sup>135</sup> the defendant or its insurer has been able to veto a structured settlement by refusing to make the assignment of the future payment liability. The Tax Code precludes the plaintiff from initiating a substitution of the future payment obligor.<sup>136</sup> This defense veto power often led to the take-it-or-leave-it offer: "Accept a structure using our broker and the company we select or take your entire settlement in cash." Many plaintiff attorneys who rightly were concerned over their own exposure to a legal malpractice claim by allowing the adversary to handle this transaction on behalf of their client simply had their clients take the cash. Now a plaintiff can agree to a cash offer. One check for all settlement proceeds is made payable to a trust in the plaintiff's name, not to the plaintiff directly. The original defendant is granted a dismissal with prejudice or satisfaction of judgment.<sup>137</sup>

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132. 26 U.S.C.A. § 468B (West 2000).

133. 26 C.F.R. § 1.468B (2000).

134. Rev. Proc. 93-34, 1993-2 C.B. 470.

135. 26 U.S.C.A. § 130(c)(1) (2000).

136. 26 U.S.C.A. Section 130(c)(1) (2000).

137. The only obligation remaining for the original defendant or its insurer is to report to the IRS the amount paid into the QSF. The QSF Administrator must file a U.S. Income Tax Return for Settlement Funds on IRS Form 1120-SF. 26 U.S.C. § 468(B).

Through the use of the QSF, the “party to the suit or agreement” for purposes of Code section 130<sup>138</sup> is no longer the defendant or its insurer. Since the QSF now has the tort liability, the defense cannot use as bargaining leverage the tax subsidy to which the injury victim is entitled by law. The original defendant is no longer a party to the claim. The QSF, which is independent of the original defendant or its liability insurer, becomes the opposing party to the claimant (or claimants). And, because the claimant has already agreed that the amount paid into the QSF is sufficient to settle all claims, there is no longer a true adversarial situation. Even though the QSF is technically the opposing party, it has no stake in saving any money at the claimant’s expense since the QSF’s objective is to disburse all assets of the fund, extinguish its tort liability, then go out of existence.

*B. The QSF is a Two-Step Process, Releasing the Defense at Step One*

A trust meets the definition of a QSF if it is created under Treasury Regulations section 1.468B-1<sup>139</sup> by a court or other specified authority to accept the settlement sum from the defendant or its insurer from a tort claim suit or agreement. A QSF may be established for other purposes such as under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA)<sup>140</sup> arising out of a tort not involving physical injury or sickness (such as emotional distress, defamation or property damage, breach of contract or violation of law), as designated by the Commissioner of Internal Revenue in a revenue ruling or revenue procedure.<sup>141</sup> However, a tort claim is the only allowable cause of action if tax-free future payments will be made, since a physical injury or physical sickness must have occurred for the payments to be excluded from the recipient’s income.<sup>142</sup> A QSF may not be established to settle a workers’ compensation claim.<sup>143</sup>

The way a QSF works is simple. The QSF trustee, on behalf of the QSF, settles all claims originally asserted against the defendant (or defendants) resulting from the event or events that gave rise to the claims by entering into settlement agreements with the person (or persons) asserting those claims. The QSF stands in the shoes of the original defendant and, according to Revenue Procedure 93-34, becomes “a party to the suit or agreement” for purposes of making a “qualified assignment” of future payment obligations under IRC section 130(c).<sup>144</sup> The use of the QSF preserves all future income tax-free benefits to the claimant that would have occurred under IRC section 104(a)(2) had the structured settlement transaction been made by the adversary’s agent, the defense broker.

A QSF is not a type of substitute product, such as a trust that invests in tax-

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138. Rev. Proc. 93-34 § 1, 1993-CB 470 (1993).

139. 26 C.F.R. § 1.468B-1.

140. 26 C.F.R. 1.468B-1(c)(2)(1).

141. 26 U.S.C.A. § 468B(d)(2)(D) and 26 C.F.R. § 1.468B-1(c)(2).

142. 26 U.S.C.A. § 104(a)(2).

143. 26 C.F.R. § 1.468B-1(g)(1).

144. Rev. Proc. 93-34, 1993-2 C.B. 470.

free bonds, that some plaintiff brokerages have developed. The concept of taking cash and investing it is nothing new, but it is not a structured settlement in its traditional sense. These substitute products do not preserve the tax-free growth of the asset under IRC section 104(a)(2).<sup>145</sup> In contrast, a QSF allows for a structured settlement transaction in its traditional sense, without the cooperation or involvement of the defendant or its liability insurer.<sup>146</sup>

Once the QSF is established and the defendant has paid an agreed upon total settlement amount into the QSF account, the liability for all such claims originally asserted against the defendant is transferred to the QSF. This is through a novation, which has the effect of adding a new party as substitute obligor which was not a party to the original duty, and discharging the original defendant by agreement of all parties. Thus, completely extinguishing any alleged liability of the defendant.<sup>147</sup>

Not only is the tort liability extinguished, but there is also no liability for any future payment. This is because future payment has not been promised before the defendant has been dismissed with prejudice. Any future payment obligation that may come out of the settlement is created between the plaintiff and the QSF after the defendant is released. This eliminates the usual defense argument that some liability may continue after the settlement. It also negates any valid reason for the defense to insist on selecting the annuity issuer. Once the assets in the QSF have been distributed, the QSF is terminated and the trustee files a fiduciary tax return.<sup>148</sup>

### *C. The Tax Code is Clear and Unambiguous Allowing the Single-Claimant QSF*

The defense settlement brokers would have plaintiffs and their attorneys believe that there are some unresolved tax questions with the use of the QSF. Over the years, the defense has used such scare tactics to maintain control of the structured settlement transaction. For years, they told plaintiffs and their attorneys that plaintiff's knowledge of the cost of the annuity constituted constructive receipt and, therefore, loss of all future tax benefits.<sup>149</sup> Next, they said that the involvement of a plaintiff broker constitutes constructive receipt.<sup>150</sup> Now, they want plaintiffs and their attorneys to believe that the use of a QSF for a single claimant triggers the doctrine of economic benefit, which would cause loss of

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145. Rev. Rul. 65-29, 1965-1 C.B. 59.

146. See generally Rev. Proc. 93-34, 1993-2 C.B. 470.

147. *Id.*

148. See generally 26 C.F.R. § 1.468B.

149. The IRS told a requesting taxpayer: "[D]isclosure by defendant of the existence, cost or present value of the annuity will not cause you to be in constructive receipt of the present value of the amount invested in the annuity." Priv. Ltr. Rul. 8333035 (May 16, 1983). In another Private Ruling it said: "Knowledge of the existence, cost and present value of the annuity contract used to fund the settlement offer. . . will not cause the family to be in constructive receipt of the amount payable under the annuity contract or the amount invested in the annuity contract." Priv. Ltr. Rul. 90-17011 (Jan. 24, 1990).

150. See ROBERT W. WOOD, *TAXATION OF DAMAGE AWARDS AND SETTLEMENT PAYMENTS*, 357 (2d. ed. 1998) (1991) (discussing constructive receipt).

future tax benefits. The IRS has not ruled on this question, but the law seems clear and unambiguous.

Under the common-law doctrine generally known as the “economic benefit,” the creation by an obligor of a fund in which the taxpayer has vested rights will result in immediate inclusion by the taxpayer of the amount funded. A “fund” is created when an amount is irrevocably placed with a third party, and a taxpayer’s interest in such a fund is “vested” if it is non-forfeitable. This principle is attributable to the landmark case *E.T. Sproull v. Commissioner*.<sup>151</sup> It is well settled in law that, when a statute or regulation is more current and more specific, the statute or regulation overrides the common law. Hence, in its application to the QSF, the common law is overridden by Treasury Regulations.<sup>152</sup>

If a plaintiff is given a security interest in the annuity contract under a section 130 qualified assignment, that triggers the economic benefit doctrine and would seem to cause all growth of the annuity to be taxable. When section 130(c) of the Code was amended by section 6079 (b)(1)(A) of the Technical and Miscellaneous Revenue Act of 1988,<sup>153</sup> the phrase “the assignee does not provide to the recipient of such payments rights against the assignee which are greater than those of a general creditor” was removed. The IRS since has acknowledged in at least one Private Ruling<sup>154</sup> that the 1988 amendment to section 130(c) of the Code “was intended to allow assignments of periodic payment obligations without regard to whether the recipient has the current economic benefit of the sum required to produce the periodic payments.” There is no adverse tax consequence. By the same rules of construction, the economic benefit doctrine should not be triggered by a single-claimant QSF.

Treasury Regulations section 1.468B-1(c)(2) says a fund, account or trust satisfies the requirements of a qualified settlement fund if “[i]t is established to resolve or *satisfy one or more* contested or uncontested claims that have resulted or may result from an event (or related series of events) that has occurred and that has given rise to *at least one* claim asserting liability. . . .”<sup>155</sup> The repeated use of the word “one” in this portion of the Internal Revenue Code makes it hard to believe that the Secretary of the Treasury meant there must be “two or more” claims. It is true that section 468B was added to the Code as a means of resolving mass tort or environmental claims, providing for a designated settlement fund (DSF). But, the Treasury Secretary, having broad authority over tax matters, expanded the concept in creating the QSF. Ordinarily one claim by a single claimant on a segregated account or trust would trigger the economic benefit doctrine. However, based on the Treasury Department’s own guidance, the obvious conclusion is that the economic benefit doctrine is not meant to apply to

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151. *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff’d*, 194 F.2d 541 (6th Cir. 1952).

152. 26 C.F.R. § 1.468B-1(c)(2).

153. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 6079 (b)(1)(A), 102 Stat. 3342.

154. Priv. Ltr. Rul. 97-03038 (July 24, 1996).

155. 26 C.F.R. § 1.468B-1 (emphasis added).



the single claimant QSF, just as it is not meant to apply to a section 130(c) qualified assignment of a future payment obligation to a single payee.

The defense brokers argue that Congress never intended section 468B of the Code to be used for settling cases with single claimants and that the "economic benefit" doctrine would be triggered unless there were two or more unrelated claimants.<sup>156</sup> These arguments were advanced to the structured settlement industry by William Neff, a tax counsel with the Washington, D.C., law firm Hogan & Hartson, L.L.P., which is retained by the National Structured Settlements Trade Association (NSSTA), during the 1997 NSSTA annual meeting in Scottsdale, Arizona.<sup>157</sup> Such a conclusion went hand-in-hand with NSSTA's bias in favor of retaining control of structured settlements by defense brokers and was met with great enthusiasm by most of those in attendance. (See Section III for a discussion of NSSTA's inherent defense bias.)

Since that 1997 presentation at the annual NSSTA, the vast majority of the NSSTA-member life insurance companies that issue settlement annuities and their affiliated assignment companies have declined to accept cases from a QSF involving only one claimant. A few major exceptions to date include ING Security Life of Denver,<sup>158</sup> CGU Life,<sup>159</sup> and John Hancock Life.<sup>160</sup> Otto J. Preikszas, Jr., a counsel on John Hancock's Tax Law staff, opined in an internal memorandum dated February 24, 2000, that a single claimant is not in constructive receipt of a fund's assets merely because he or she is the only claimant and, therefore, at some

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156. Memorandum from Randy Dyer, Executive Director, National Structured Settlements Trade Association (NSSTA), to a member of NSSTA (Jan. 31, 1997) (on file with author). It states on the subject of single-case 468B trusts:

[i]f memory serves, Keith Lakey at SAFECO [Life Insurance Company] reported on a conversation he had with a Treasury official who led him to believe that, regardless of the potential confusion created by the language, such trusts were not intended for use in cases involving a single claimant. I recall the Treasury representative being quoted as saying, "[t]hese trusts were never intended to exist for an hour."

The Dyer memo was distributed to NSSTA members at its 1997 Annual Meeting, May 7-11, in Scottsdale, Arizona. This commentator, in December 1999, spoke to Michael J. Montemurro, Senior Technician Reviewer, Branch 2, Income Tax & Accounting Division, Internal Revenue Service, Washington, D.C., who confirmed that there was internal "tension" among staff officials at the IRS on the legality of the use of 468B trusts (qualified settlement funds) when there was only one claimant to benefit from the trust. But, he said no official IRS position had been formulated and that the issuance of a Revenue Ruling any time soon was unlikely. Mr. Montemurro's name appears as the drafter of numerous IRS letter rulings pertaining to structured settlements.

157. Bill Neff, Presentation at NSSTA Annual Meeting (May 9, 1997) (notes on file with author). In Mr. Neff's opinion, as reconstructed from the commentator's notes: 1) There is a high level risk associated with a single party 468B claim; 2) If unrelated claimants, there is a low risk; but, in the absence of adverse interest, there may be a problem; 3) If the parties are related, there is a problem if there is an agreement (at the time the fund is created) as to the share to each party; and 4) It is better if the QSF is created in the case of a minor (or incompetent), subject to court approval. *Id.* He stressed that, in his opinion, the problem with a single-claimant QSF is the economic benefit doctrine. *Id.* This commentator respectfully disagrees with Mr. Neff's opinions, for reasons stated herein.

158. ING Security Life of Denver withdrew from the structured settlements marketplace effective September 1, 2000. *See* note 75. Its structured settlements unit was purchased by Massachusetts Life Insurance Company, as a means of entering the marketplace.

159. CGU Life Insurance Company (formerly Commercial Union Life Insurance Company), Boston, Mass.

160. John Hancock Life Insurance Company, Boston, Mass.

time must receive such assets. Citing the constructive receipt doctrine, he asserts that such single claimant must have some right to recover or to use the assets without restriction or limitation in order to be in constructive receipt.<sup>161</sup> He also notes that examples of constructive receipt contained in Code sections 130 and 468B do not include a QSF having only a single claimant.<sup>162</sup> Preikszas also points out that the Conference Committee Reports with respect to the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") provide that a liability assignment is treated as a qualified assignment notwithstanding that the recipient is provided creditor's rights against the assignee greater than those of a general creditor.<sup>163</sup>

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161. *Id.*

162. The following are pertinent excerpts from the February 24, 2000, internal memorandum (used with permission of its author on behalf of his employer) by Otto J. Preikszas, Jr., a counsel on John Hancock's Tax Law staff:

I do not believe that a single claimant is in constructive receipt of a fund's assets merely because he or she is the single claimant. Such single claimant must have some right to recover or to use the assets without restriction or limitation in order to be in constructive receipt of the fund's assets.

Income Tax [Treasury] Reg. [§] 1.451-2(a) provides that income is constructively received in the taxable year during which it is credited to the individual's account, set apart for the individual, or otherwise made available so that the individual may draw upon it at any time. Income is not constructively received if the individual's control of its receipt is subject to substantial limitations and restrictions. Typically an individual is found to be in constructive receipt of income if the individual has the right to either elect a cash payment in lieu of deferring receipt of income, has the right to terminate a deferral arrangement at will (without giving up any "valuable rights") and receive a cash payment and, in some cases, if the arrangement is funded.

Unless a single claimant of a fund has a right to elect a cash payment in lieu of fund establishment or to terminate the fund at will and receive a cash payment (or has a similar such right), it is my position that such a claimant is not in constructive receipt of the funds assets merely because that person is a single claimant. . . .

In addition, please note that, in Rev. Proc. 93-34, the IRS provides rules under which a 468B fund will be considered a "party in interest" for purposes of Code section 130. I am not aware of any provision under section 130 that would cause a single claimant to be in constructive receipt of any amount of a qualified assignment established on his or her behalf merely because there is only one claimant. In fact, the Conference Committee Reports with respect to TAMRA provide that a liability assignment is treated as a qualified assignment notwithstanding that the recipient is provided creditor's rights against the assignee greater than those of a general creditor. *No amount is currently includible in the recipient's income solely because the recipient is provided creditor's rights that are greater than the rights of a general creditor.* (This is the funding aspect of constructive receipt.)

Finally, I note that [Income Tax Regulations §] 1.468B-3(f)(2)(ii) provides that to the extent that the transferor of amounts to fund acquires a right to a refund or reversion of the fund's assets is in constructive receipt of such assets. There is no other regulation under [Tax Code] section 468B (or section 130) dealing with instances in which a claimant may be in constructive receipt.

Based on the above, it is my opinion that a single claimant of a section 468B fund is not in constructive [receipt] of the fund's assets merely because such person is the only claimant.

Memorandum from Otto J. Preikszas, Jr., counsel, John Hancock, to Christi Fried, Director of Structured Settlement (Feb. 24, 2000) (on file with author).

163. §6079(b)(1)(A). It reads in part:

The determination for purposes of this chapter of when the recipient is treated as having received any payment with respect to which there has been a qualified assignment shall be

A further examination of Congress' intent creating designated settlement funds and in delegating authority to the Secretary of the Treasury to promulgate regulations governing these funds demonstrates conclusively that such funds may be used when there is only a single claimant.<sup>164</sup> The statute, 26 U.S.C. section 468B(d)(2), defines a "designated settlement fund" as any fund

which is established pursuant to a court order and which extinguishes completely the taxpayer's tort liability with respect to claims described in subparagraph (D)...[and] which is established for the principal purpose of resolving and satisfying present and future claims against the taxpayer (or any related person or formerly related person) arising out of personal injury, death, or property damage. . . .<sup>165</sup>

The Code also authorizes a tax deduction for payment into the fund by saying "[f]or purposes of section 461(h), economic performance shall be deemed to occur as qualified payments are made by the taxpayer to a designated settlement fund."<sup>166</sup> There is no suggestion whatsoever in the language of the Code that more than one claimant is required, unless one unreasonably construes the term found in subparagraph (d)(2)(D), "satisfying present and future claims," to mean a requirement of multiple claimants.

Section 468B was created to give a defendant in a mass tort claim the ability to settle it even before all the plaintiffs have been identified. But, there is no way to be sure that there would be multiple claimants if they have not been identified at the time the QSF is established. Suppose there was an explosion and fire in a building, but the number of occupants at the time of the explosion and fire

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made without regard to any provision of such assignment which grants the recipient rights as a creditor than those of a general creditor.

*Id.*

164. The statute authorizes the creation of a "designated settlement fund." 26 U.S.C.A. § 468B. However, the implementing regulation, 26 C.F.R. § 1.468B, refers to a "qualified settlement fund." 26 C.F.R. § 1.468B (2000).

165. 26 U.S.C.A. § 468B(d)(2) reads:

The term "designated settlement fund" means any fund—

(A) which is established pursuant to a court order and which extinguishes completely the taxpayer's tort liability with respect to claims described in subparagraph (D),

(B) with respect to which no amounts may be transferred other than in the form of qualified payments,

(C) which is administered by persons a majority of whom are independent of the taxpayer,

(D) which is established for the principal purpose of resolving and satisfying present and future claims against the taxpayer (or any related person or formerly related person) arising out of personal injury, death, or property damage,

(E) under the terms of which the taxpayer (or any related person) may not hold any beneficial interest in the income or corpus of the fund, and

(F) with respect to which an election is made under this section by the taxpayer.

An election under this section shall be made at such time and in such manner as the Secretary [of the Treasury] shall by regulation prescribe. Such an election, once made, may be revoked only with the consent of the Secretary.

166. 26 U.S.C.A. § 468B(a).

unknown. Next, suppose one body is recovered and the spouse brings suit on a negligence theory against the building owner. The liability insurer may obtain a court order to establish a QSF on the probability that there were more victims, obtaining release of tort liability from all victims, known and unknown. The QSF is substituted for the building owner under a novation<sup>167</sup> and assumes all liability for the damages caused by the explosion and fire. If no more victims are identified, the entire fund assets may be paid to only one claimant. Certainly, the drafters of this statute anticipated this scenario and never intended that the surviving spouse of the single victim would lose the tax benefits that otherwise would have resulted had there been more than one victim.

The Secretary of the Treasury, in issuing 26 C.F.R. section 1.468B, defined a "qualified settlement fund" using the word "one" claim.<sup>168</sup> In the unlikely event that the Secretary inadvertently used the word "one" more than once in defining a QSF, intending to mean "two" (as some claim), there was plenty of opportunity to say that a fund involving a single-claimant did not qualify. Subparagraph (g) lists "excluded liabilities" and fails to name any liability involving a single claimant.<sup>169</sup>

Additionally, the proposed Treasury Regulations section 1.468B, in its entirety, was subject to the rule making procedure prescribed in section 553 of the Administrative Procedure Act.<sup>170</sup> This process calls for publication in the Federal Register and the opportunity to voice opinions before the rule can take effect. Certainly, even if the use of the word "one" was inadvertent, its unintended impact would have been raised during the public comment process. Therefore, the use of the word "one" was not questioned. The reasonable conclusion is that it was intended.

As further evidence that the Secretary did not intend to preclude the use of a QSF with just one claimant, Treasury Regulations sections 1.468B-1(k) gives seven scenarios, stating whether or not the acts taken would result in a QSF or what actions must be taken to qualify the fund. In no example is it suggested that having only a single claimant would disqualify the fund.<sup>171</sup> And, as Mr. Preikszas notes, section 1.468B-3(f)(2)(ii) is the only instance in both the Code and Treasury Regulations, based on Code sections 130 and 468B, where an instance of constructive receipt is described. There was plenty of opportunity for Congress or the IRS, through the Code and Treasury Regulations, to preclude the use of a

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167. See *supra* note 49 for additional background on a novation.

168. 26 C.F.R. § 1.468B-1(c).

169. Excluded under 26 C.F.R. § 1.468B-1(g) are any liability that:

- (1) Arises under a workers compensation act or a self-insured health plan;
- (2) Is an obligation to refund the purchase price of, or to repair or replace, products regularly sold in the ordinary course of the transferor's trade or business;
- (3) Is an obligation of the transferor to make payments to its general trade creditors or debtholders that relates to a title 11 or similar case. . . , or a workout; or
- (4) Is designated by the Commissioner in a revenue ruling or a revenue procedure. . . .

170. The Administrative Procedure Act of 1946 is codified at 5 U.S.C.A. § 551 (West 2000).

171. 26 C.F.R. § 1.468B-1(k) (2000).

QSF for a single claimant on the economic benefit theory. Its use in single-claimant cases was not precluded.

It would seem reasonable that, because it promulgated the regulations authorizing a single-claimant QSF, the IRS has no inclination to challenge the validity of a fund so created. Any such challenge would need to come from other than the IRS, as the IRS must live by its own rules. If the parties agree to establish a QSF, who else with standing is there to bring a challenge?

Some suggest that the Secretary exceeded the authority granted by Congress under the statute by authorizing the use of the QSF for "at least one claim asserting liability." As such, these people contend, there is no authority for the single-claimant QSF. Section 7805(a) of the Code provides this authorization:

Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary [of the Treasury] shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.<sup>172</sup>

With this broad charter granted to the Secretary, there have been challenges over the years to the Secretary's authority. It may be helpful to review some construction from the U.S. Supreme Court:<sup>173</sup>

The Secretary was authorized by statute to make regulations, not inconsistent with law. . . The Constitution gives Congress power to make all laws necessary and proper for carrying into execution the powers vested by that instrument in the government of the United States or in any department or officer thereof.<sup>174</sup>

Incidental to Commissioner's authority to administer income tax law is power to make regulations for information of taxpayers, guidance of the collectors, and realization of purposes of the taxing acts.<sup>175</sup>

Treasury regulations are valid unless unreasonable or inconsistent with statute.<sup>176</sup>

[A]s contemporaneous constructions by those charged with administration of Internal Revenue Code, [Treasury] Regulations must be sustained unless unreasonable and plainly inconsistent with revenue statutes, and should not be overruled except for weighty reasons.<sup>177</sup>

As pointed out earlier, this case law evolved from challenges by taxpayers to regulations issued by the Treasury Secretary. If there is a challenge to the regulation in question, it would be from the Treasury Department, in contravention to its own rules. And, that is unlikely because an agency must abide

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172. 26 C.F.R. § 7805(a) (2000).

173. The following cases from notes 148- 152 reflect the Court's interpretation of the Secretary's authority. See also 26 U.S.C.A. §7805 (West 2000).

174. *Boske v. Comingore*, 177 U.S. 459, 469-469 (1900).

175. *Spreckels v. Commissioner*, 119 F.2d 667, 669 (1941), *aff'd sub. nom. Spreckels v. Helvring*, 315 U.S. 626 (1942).

176. *Fawcus Machine Co. v. United States*, 282 U.S. 375, 378 (1931).

177. *Fulman v. United States*, 434 U.S. 528, 533 (1978) (quoting *Bingler v. Johnson*, 394 U.S. 741, 749-750 (1969) (alterations in the original)).

by the rules it sets. Obviously, the taxpayer is not going to initiate a challenge against his or her own interest. Who else would have standing?

The regulations in this instance are in no way inconsistent with the statute that authorizes the concept of the designated or qualified settlement fund—by whatever label we wish to call it. Case law clearly indicates that the courts have no intention of ruling against a taxpayer whenever the Treasury Regulations are plainly consistent with the statute. The risk to the plaintiff's attorney, therefore, of a legal malpractice claim brought by his or her client for allowing an adversary to handle the structured settlement for the client seems to be far greater than any tax risk claimed by the opponents of the single-claimant QSF.

Should the IRS challenge a qualified assignment from a QSF on the basis that the QSF was established for a single claimant, the taxpayer will have been denied the constitutional right of due process. The Fifth Amendment to the Constitution states:

"No person shall be . . . deprived of life, liberty, or property, without due process of law."<sup>178</sup> Due process requires notice and the opportunity to be heard, according to *Mullane v. Central Hanover Bank & Trust Co.*<sup>179</sup> To enforce a regulation duly created under the Administrative Procedure Act, at 5 U.S.C. section 553<sup>180</sup>, in a manner contrary to the clear language of that regulation, would constitute lack of notice, and thus, deny due process to the affected taxpayer. That would offend the Constitution.

## VII. CONCLUSION

Discourage litigation. Persuade your neighbors to compromise whenever you can. Point out to them how the nominal winner is often a real loser—in fees, expenses and waste of time. As a peacemaker the lawyer has a superior opportunity of being a good man.

Abraham Lincoln (1850).

While the internal conflict between defense brokers and plaintiff brokers will continue, the plaintiffs' attorneys are becoming more educated about the risk of legal malpractice exposure from current practices by a large number of liability insurers and the brokers who work with them. They are also beginning to be more assertive in rejecting the involvement of defense consultants in the financial future of their clients. Additionally, life insurance companies are accepting assignment of future payment obligations from the qualified settlement fund, regardless of the number of claimants to be paid from the fund.

The future of the structured settlement is bright. As plaintiffs increasingly are allowed to deal with structured settlement experts of their choice, and to select the annuity issuer and assignee, more cases will likely include periodic payments in their settlement terms. Attorneys are more comfortable with the idea of

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178. U.S. CONST. amend. V.

179. 339 U.S. 306, 314 (1950).

180. 5 U.S.C.A. § 553 (2000).

structuring their fees, even though the IRS has never recanted its position that did not prevail either in Tax Court or at the U.S. circuit court appellate level. Recent changes in the tax code have provided certainty and stability to structured settlements and their significant tax advantages. The long-standing dispute between the settlement brokers and settlement payment purchasers is over. NSSTA opposition to the settlement purchases may not have been motivated just by a desire to curb abuses of high interest rates and disrupting periodic payments needed by catastrophically injured payees for basic living needs. Based on NSSTA's history of drawing attention away from other problems looming in the structured settlement industry, namely the stagnation of sales and the shift of control to plaintiff advocates, the war waged on NASP may have been a diversionary measure (a "red herring"). Settlement of this dispute offers the opportunity for NSSTA to address its internal strife.

While statistics are elusive, the general projection among industry observers is that there is room for growth.<sup>181</sup> The structured settlement is poised to become an even more prevalent force than ever before in resolving large-dollar claims.

This commentator has heard anecdotal evidence from several defense attorneys who concede, after negotiations have resulted in a settlement, that the periodic payments designed by the broker of the plaintiff's own choosing were instrumental in bringing about the settlement. Plaintiffs are more receptive to periodic payment options when proposed by someone in the plaintiff's own camp than when coming from the plaintiff's adversaries. Yet, for the prospect of saving perhaps as little as one percent<sup>182</sup> of the settlement proceeds, defendants and their liability insurers will insist on foisting an adversarial structured settlement broker onto the injury victim. Perhaps they do not realize this factor alone often is the reason a case does not settle prior to trial. Defendants and their insurers should consider the number of cases that do not settle during negotiations, including formal mediations, because the money offered is perceived by the plaintiff to be too little and the offer of periodic payments is viewed as nothing more than an attempt to make a little amount of money look like a lot.

On the other hand, if the claimant is hearing from his or her own trusted structured settlement expert how a cash offer would provide lifetime income, the offer is more likely to be received. The percentage of cases settling in lieu of trial would increase dramatically, in this commentator's opinion, if the negotiations

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181. See generally *Growing Our Business*, NSSTA NEWSLETTER (Nat'l Structured Settlements Trade Ass'n, Wash., D.C.), June 2000, at 4.

182. This considers that approximately half of the settlement "present value" dollars the defense is willing to pay to settle the claim will be paid in cash for costs, expenses, medical liens and attorney fees. If the commission to be paid by the annuity issuer is four percent, and half of the settlement proceeds will be applied toward the purchase of an annuity by the assignee, the resulting commission will be roughly two percent of the total settlement cost. If the commission is split 50-50 between the defense broker and the liability insurer, the insurer and the broker each receive a commission equal to about one percent of the total settlement proceeds. On an annuity costing \$1 million, the liability insurer would receive a rebate of \$10,000.

were strictly in terms of cash paid at the time of settlement accompanied with a structured settlement broker advising the plaintiff as an ally, rather than an adversary.

*Richard B. Risk, Jr.*



