

April 5, 2014

**Memorandum for the
National Structured Settlements Trade Association**

Re: Marketing and Distribution of Factored Structured Settlement Payment Rights

In June 2012 the NSSTA Board wrote to the membership to clarify that engaging in or promoting the marketing or distribution of payment rights previously acquired in a structured settlement factoring transaction (referred to in this memorandum as “recycled payment rights”) are activities that are inconsistent with NSSTA’s mission. Recent developments have led to renewed questions about use of recycled payment rights as an investment vehicle and even as a means of funding future settlement payments. This memo will recapitulate some of the reasons for the conclusion reached in the Board’s June 2012 letter.

Apart from the fact that they provide support and financing for structured settlement factoring, marketing and distribution of recycled payment rights link structured settlements with risky, unregulated investment activity that can lead to –

- losses for investors and settling claimants who may acquire recycled payment rights as a source of future payments;
- needless disputes and litigation for insurers; and
- damaging publicity that confuses recycled payment rights with structured settlements.

Because they derive from structured settlements and from transactions that must receive advance court approval in order to comply with State structured settlement protection acts (“SSPAs”) and to avoid incurring excise tax under Internal Revenue Code (“IRC”) § 5891(a), recycled payment rights sometimes mistakenly are equated with the rights of structured settlement payees themselves. They are not equivalent.

As the Securities and Exchange Commission and the Financial Industry Regulatory Authority (FINRA) warned in a May 2013 Investor Alert: while the yield associated with recycled payment rights may look attractive,

[I]nvestors should be aware of the following:

- These products can be expensive. You may encounter commissions of 7 percent or higher.
 - . . . [S]tructured settlement income stream products may . . . be securities and likely are not registered with the SEC. As such, reliable information . . . may be difficult to find and resolving disputes should an investment go sour may also be difficult.
- * * * *
- Your “rights” to the income stream you purchased could face legal challenges. 1/

That warning was understated.

As an initial matter, recycled payment rights are no better than the rights of the structured settlement payee at the time the payment rights were purchased from that payee. If, for example, the payee’s rights were subject to a tax lien or a lien for payment of child support or other domestic support obligations, the rights remain subject to those encumbrances when they are purchased by a factoring company and sold as recycled payment rights. If the structured settlement payee has gone through bankruptcy proceedings without properly identifying the structured settlement as a bankruptcy estate asset and establishing that the settlement is exempt from creditors’ claims, the payee’s bankruptcy estate and creditors may be entitled to reclaim the payments. 2/ In these and other circumstances in which a structured settlement payee’s rights are encumbered or may be claimed by another party, the

1/ *Investor Bulletin: Pension or Settlement Income Streams – What You Need to Know Before Buying or Selling Them*, SEC Pub. No. 143 (5/13).

2/ See, e.g., *Novak v. Drake (In re Drake)*, Adv. No. 08–02118, Bankr. No. 07–21678, 2012 WL 1095501 (Bankr. D. Conn. March 29, 2012); *Swartz v. Moffett (In re Moffett)*, Adv. No. 10–7094, Bankr. No. 10–71920, 2012 WL 359765 (Bkrtcy.C.D.Ill. Feb. 2, 2012).

purchase and recycling of those rights does not eliminate the encumbrance or extinguish the interest of the other party. ^{3/}

Recycled payment rights may also turn out to be of little or no value because they are subject to the kinds of “legal challenges” to which the SEC and FINRA have alerted investors. Factored structured settlement payment rights have proven to be unenforceable because the underlying payment rights were purchased from the payee in a transaction that failed to comply with SSPA requirements or violated other applicable laws; because the factoring transaction was fraudulent; or because the underlying settlement agreement did not give the payee the ability to convey the applicable payment rights. For example:

- In Settlement Funding, LLC v. Brenston, 998 N.E.2d 111 (Ill. App. 2013), petition for leave to appeal denied (Ill. S. Ct., No. 116698, Nov. 27, 2013), the Illinois Appellate Court ruled that Illinois Circuit Court orders entered in 2007 and 2008 approving two factoring transactions under the Illinois SSPA were void ab initio, because the statute did not apply to them. The Appellate Court thus retroactively invalidated two factoring transactions involving continuing payments, long after the factoring company had paid for, and ostensibly had acquired, the payment rights.
- In Rapid Settlements, Ltd. v. United States Fidelity & Guaranty Co., 672 F. Supp.2d 714 (D. Md. 2009), the United States District Court ruled that a 2004 order of a Louisiana court approving a transfer of payment rights under the Louisiana SSPA was void and that the factoring company had acquired no rights under the settlement, because the Louisiana court lacked authority under the Louisiana SSPA to approve the transfer, which violated the Maine Workers’ Compensation Act.
- In dozens of cases that reportedly are the subject of a criminal investigation in New York, Paris & Chaikin, PLLC, a law firm that has represented several of the largest factoring companies, has reported that a “rogue” paralegal formerly employed by the firm committed “serious acts of fraud, criminal and other related misconduct,” including “creating fraudulent court-related documents” in connection with SSPA proceedings. ^{4/} The fraudulent documents included fake petitions seeking court approval of factoring transactions and fake court orders ostensibly approving such transactions. See J.G. Wentworth Originations, LLC v. Hall, No. 2013-0274, 2014 WL 1236669 (N.Y. Sup. March 25, 2014), at *4.
- In J.G. Wentworth LLC v. Christian, No. 07 MA 113, 2008 WL 2486552 (Ohio Ct. App. June 17, 2008) a factoring company repeatedly purchased rights to receive settlement

^{3/} See, e.g., Restatement (First) of Contracts § 167(1) (1962) (“An assignee’s right against the obligor is subject to all limitations of the obligee’s right . . .”).

^{4/} J.G. Wentworth Originations, LLC v. Tyson, No. 2014/0082 (Oswego Cty. N.Y. Sup. Ct.), Feb. 20, 2014 Verified Petition, Exhibit G (Further Affirmation of Ian Chaikin) ¶¶3-4.

payments that were to be made to the payee's daughters, as his designated beneficiaries, in the event of his death. The payee died, and the factoring company sought a declaratory judgment that it was entitled to receive the factored settlement payments. The Ohio Court of Appeals ruled for the daughters, explaining that "the decedent had the right to the scheduled payments while alive, but only the named beneficiary had the right to the scheduled payments thereafter." 5/

Factoring companies and investors in recycled payment rights also face a risk of federal excise tax liability. If the Internal Revenue Service determines that a factoring transaction was not properly authorized in advance in a State court order satisfying the conditions for a "qualified order" under IRC § 5891(b)(2), the factoring company or investor may be obligated to pay an excise tax equal to 40 percent of the difference between the aggregate (undiscounted) amount of the factored payments and the net amount paid to the payee. 6/

Because factoring companies and their agents often are responsible for receiving factored structured settlement payments and subdividing them among investors (and, if applicable, returning portions of the payments to the structured settlement payees), investors in recycled payment rights run the risk that a factoring company or its agent may misappropriate payments or may go into bankruptcy and be unable to process payments. (Structured settlement payees can face the same risk when they sell rights to receive portions of future payments.)

Even in cases in which recycled payment rights derive from structured settlement payments that are free and clear in the hands of the payee and are purchased in factoring transactions that comply

5/ Under similar circumstances the Louisiana Court of Appeals in In re Alexandra Cook, 859 So.2d 13 (La. App. 2003) ruled that following the deaths of a payee who had factored his payment rights his designated beneficiary, not the factoring company, was entitled to receive the payments. The factoring transactions in Wentworth v. Christian and In re Alexandra Cook predated enactment of applicable SSPAs and thus were not submitted for court approval; but nothing in the SSPAs would have changed the outcome, which in each case was based on fundamental contract law principles.

6/ IRC § 5891(a) imposes a 40 percent excise tax on "any person who acquires directly or indirectly structured settlement payment rights in a structured settlement factoring transaction" (emphasis added) that is not exempted under IRC § 5891(b). IRC § 5891(b) provides an exemption for transactions that are approved in advance in "qualified orders" entered under the authority of the SSPAs. In the absence of a valid "qualified order" both the factoring company that acquires payment rights from the payee and any investor(s) that acquire the payment rights indirectly, i.e., as recycled payment rights, can be held liable for the excise tax.

with all applicable legal requirements, recycled payment rights do not begin to enjoy the protections that are integral to structured settlements. See the following comparison:

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Recycled Payment Rights 7/

All payments, including amounts attributable to annuity earnings, are excludable from the payee’s gross income under IRC § 104(a).	Factored payments (other than return of amounts invested) are fully taxable.
Payments are directly backed by annuity contracts, under which the payee is an intended third-party beneficiary and generally is the named annuitant.	Factored payments are backed only indirectly by annuity contracts, under which the recipient of the payments is neither an intended third-party beneficiary nor the named annuitant.
In the unlikely event of an annuity issuer’s insolvency, payments are protected by State life and health insurance guaranty association coverage of payees under structured settlement annuities. <u>8/</u>	Factored payments are not entitled to guaranty association protection.
In many States payments can be shielded from claims of a payee’s creditors (and excluded from his or her bankruptcy estate if bankruptcy relief becomes necessary) under exemption laws applicable to structured settlement annuities. <u>9/</u>	Annuity exemptions do not apply. Factored payments are not shielded from claims of a recipient’s creditors or excludable from a recipient’s bankruptcy estate.

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NSSTA’s primary mission is “to promote the establishment and preservation of structured settlements in order to provide long-term financial security to personal injury claimants and their families through periodic payment of compensation.” (NSSTA Bylaws, Article I, Section 3.) For the

7/ Including both interests in individual factored settlements and interests in multiple factored settlements that have been pooled and repackaged, e.g., as part of securitizations.

8/ Coverage is subject to statutory coverage limits, generally at least \$250,000 and in some States \$500,000 or more in present value of annuity benefits.

9/ See, e.g., Fla. Stat. § 222.14, applied in In re Belue, 238 B.R. 218 (Bankr. S.D. Fla. 1999); N.Y. Ins. Law § 3212(d)(1), applied in Swimelar v. Baker (In re Baker), 604 F. 3d 727 (2d Cir. 2010). Over 20 States have enacted exemption statutes closely resembling these Florida and New York statutes. In many States structured settlements also qualify for protection under other kinds of exemption statutes.

reasons summarized above, marketing and distribution of recycled payment rights, like structured settlement factoring itself, subvert that mission. Hence the Board's conclusion that they are inconsistent with NSSTA's membership qualifications.