A3786/S4306 Will Significantly Curtail the Use of Structured Settlements To Compensate Injury Victims and Their Families in New York State

Executive Summary

- The National Structured Settlements Trade Association, the trade association of the structured settlement industry, strongly opposes A3786 and S4306.

- Structured settlements have been used to provide long-term financial security to injury victims and their families throughout New York State and across the country for almost 3 decades.

- The proposed legislation would upset the settlement negotiation process that has been so successful in New York. The result will be fewer structured settlements for injury victims.

- Under the proposed legislation, if the parties cannot agree on the funding source for the periodic payments under the structured settlement "prior to final approval of the settlement agreement", the legislation directs that the plaintiff can choose the funding source. If this proposed provision is interpreted to mean that after the settlement agreement is finalized, the plaintiff would have the unilateral ability to impose the funding source on the defendant without regard to cost, thereby effectively dictating the cost of the settlement to the defendant, the defendant will have little interest in participating in the structured settlement in the first instance.

- If instead the provision means that the defense simply turns control of the lump sum of cash to fund the structured settlement over the plaintiff who then picks the funding source, Federal tax risks would be created for the plaintiff.

Background

The National Structured Settlements Trade Association (NSSTA) is the association of the structured settlements industry. NSSTA is composed of more than 500 members throughout the country, who negotiate and fund structured settlements of tort and worker's compensation claims involving persons with serious long-term physical injuries, including more than 60 members in New York State.

NSSTA represents all aspects of the structured settlements industry. Its members include: the structured settlement brokers who work with plaintiff counsel and defense counsel to develop, negotiate, and implement the structured settlement for the injured victim; the life insurance companies that fund the structured settlements through annuities; the property and casualty companies that enter into the structured settlement with the injured plaintiff to resolve his or her physical injury claim; and various plaintiff and defense attorneys and economists active in the structured settlement field.

Structured settlements are voluntary arrangements reached through negotiation and compromise between the two parties. Structured settlements provide injury victims and their families with long-term financial security through an assured stream of payments tailored to the victim's needs throughout his or her lifetime. Thus, structured settlements enable seriously-injured, often profoundly disabled people to live with dignity and financial independence, free of reliance on government-financed assistance programs and interference.

The negotiation of a structured settlement takes place within a framework that provides multiple layers of protection for the claimant:

- The Federal tax law in Internal Revenue Code section 130 lays out requirements for the terms and funding of the structured settlement.

- State insurance licensing and regulatory requirements already apply. The structured settlement annuity issuer is subject to licensing and regulation under State insurance laws. The annuity is subject to review and approval by the State insurance regulator. Structured settlement brokers are licensed by State insurance regulators.

- Industry experience is that claimants in serious physical injury cases are represented by counsel in structured settlement negotiations, and most often both parties are receiving independent advice from their own structured settlement brokers.

- Industry practice is to provide the claimant and counsel with a detailed factual presentation regarding the cost of various components of the settlement, including the annuity cost and total future payout for the structured payments. Industry practice also is to spell out the annuity cost as part of the settlement offer. Plaintiff's counsel has to know the cost of the structured settlement annuity in order to calculate the attorney's fee, which must be determined on the basis of the present value of the settlement.

- A significant number of tort cases involving structured settlements are now settled under watchful eye of a mediator.

The current approach to structured settlements has the strong support of the plaintiff's bar, the defense bar, judges, mediators, and groups representing persons with disabilities such as the American Association of People with Disabilities and the National Council on Disability.

Structured settlements are in broad use today not only in the private sector in resolving tort physical injury and worker's compensation claims, but also in the government sector. The Federal Government uses structured settlements in a variety of contexts, including the Vaccine Compensation Fund, Federal Tort Claims Act, compensation for military families, and the September 11 Victims' Compensation Fund. The State of New York, the City of New York, and cities and counties across the State use structured settlements every day to resolve physical injury claims brought by citizens.

The Proposed Legislation Will Place the Parties to a Structured Settlement in an Untenable Position

The proposed legislation would upset the settlement negotiation process that has been so successful in enabling the parties to resolve a tort or worker's compensation claim with the long-term financial security of a structured settlement for the injured claimant and his or her family. Under the proposed legislation, if the parties cannot agree on the annuity issuer or other funding source for the periodic payments under the structured settlement "prior to final approval of the settlement agreement", "the claimant may, through the claimant's settlement broker, designate a source or insurer of his choice to so fund the agreement." (Prop. Sec. 5-1702-A(B)).

This provision of the proposed legislation can be interpreted in two ways, both of which would place the parties to a structured settlement in an untenable position:

- If the rule would be that after the settlement agreement is finalized, the plaintiff would have the unilateral ability to impose the funding source on the defendant without regard to cost, thereby effectively dictating the cost of the settlement to the defendant, the defendant will have little interest in participating in the structured settlement in the first instance.

- If instead the provision means that the defense simply turns control of the lump sum of cash to fund the structured settlement over the plaintiff who then picks the funding source, Federal tax risks would be created for the plaintiff.

The Proposed Legislation Would Significantly Curtail the Use of Structured Settlements to Compensate Injury Victims and Their Families in New York

- ***Defendants will not enter into a structured settlement where the plaintiff has the unilateral ability to dictate its cost***

Under the current longstanding structured settlement practice, the stream of periodic payments is negotiated between the parties with an eye to the cost of the settlement to the defendant. In the competitive structured settlement market, different annuity issuers have differing rates for funding a particular stream of periodic payments. Similarly, a total settlement payment by the defendant will translate into higher or lower streams of periodic payments, depending upon the particular annuity issuer. Accordingly, both the stream of the periodic payments and the overall cost of the settlement to the defendant in the form of the cost of the funding source are the subject of negotiation between the parties at the settlement table.

If the rule would be that after the settlement agreement is finalized, the plaintiff would have the unilateral ability to impose the funding source on the defendant without regard to cost, the plaintiff would be effectively dictating the cost of the settlement to the defendant. At the time of settlement, the defendant would not know what it is agreeing to in terms of cost. A defendant will have little interest in entering into a structured settlement where it has no role in setting the cost.

This concern is particularly pronounced in structured settlements of workers' compensation claims for injuries in the workplace. In these cases, the employer and its compensation carrier often have some continuing liability and purchase and hold ownership of the annuity that funds its obligation to make the periodic payments under the structured settlement of the worker's compensation claim. Under the proposed legislation, the plaintiff would have the unilateral ability to dictate the cost of that annuity to be purchased and owned by the employer or compensation carrier to fund its periodic payment obligations to the claimant.

- ***The proposed legislation will discourage the participation of the party most likely to raise structured settlements as an option for resolving the case***

The experience of the tort system is that well more than half of all personal injury claims are resolved through cash settlements. Cash settlements simply are easier to understand, measure, and implement. The simple fact is that an education process is needed to inform injured claimants and their counsel about the concept and benefits of a structured settlement. Industry experience further demonstrates that when the claims community embraces and encourages the consideration of structured settlements in the negotiation process, plaintiffs and their counsel are more willing to take the time and effort to work through the more complicated periodic payment approach, and more cases settle with a structure, providing long-term financial security to the claimant and his or her family. Indeed, industry experience suggests that in the majority of cases, it is the defense that introduces the concept of a structured settlement at the negotiating table with the claimant.

If the defense has no voice in the choice of the annuity provider or in determining the cost of the structured settlement, its lack of role and lack of ability to protect its interests will translate into a lack of interest in promoting use of structured settlements. The practical reality born of industry experience is that, as a result, fewer claimants will learn of the structured settlement tool and fewer physical injury cases will be settled on the basis of a structured settlement.

- ***Defendant's concerns over liability exposure will discourage its participation***

In addition, because of liability exposure, the defense will not wish to be a party to a structured settlement under a funding arrangement established unilaterally by the other party. For example, the plaintiff could choose a funding source that turns out not to qualify under the Federal tax rules governing structured settlements on Internal Revenue Code section 130, jeopardizing the defendant's ability to deduct the full cost of the settlement in a transaction over which the defendant has no control.

Further, if the annuity provider unilaterally chosen by the plaintiff is a high return, high risk enterprise, the defense side may be responsible for any subsequent shortfalls in payments. This is a major concern in structured settlements of workers' compensation cases where the employer and its compensation carrier often have some continuing liability and purchase and hold ownership of the annuity that funds its obligation to make the periodic payments under the structured settlement of the worker's compensation claim.

At the end of the day, if the defense is unable to participate to protect its interests in the choice and cost of the funding source for the structured settlement, a lump sum cash settlement simply is easier.

<u>The Proposed Legislation Would Create Federal Tax Risks for the Injury Victim</u>

If, instead, the proposed provision means that the defense simply turns control of the lump sum of cash to fund the structured settlement over the plaintiff who then picks the funding source, the plaintiff would face serious Federal tax risks.

In enacting the Federal structured settlement tax rules under sections 130 and 104(a)(2) of the U.S. Internal Revenue Code, Congress stated: "This provision is intended to codify, rather than change, present law. Thus, the periodic payments as personal injury damages are still excludable from income only if the recipient taxpayer is not in constructive receipt of or does not have the current economic benefit of the sum required to produce the periodic payments. *See* Rev. Rul. 79-220 and Rev. Rul. 77-230." (House Rept. No. 97-832, 97th Cong., 2d Sess. (1982), at 4; Sen. Rept. No. 97-646, 97th Cong., 2d Sess. (1982), at 4).

In Rev. Rul. 79-220, the I.R.S. held that where the plaintiff and defendant had agreed to settle a personal injury claim on the basis of the defendant's promise to make future periodic payments, the full amount of such payments constituted tax-free damages under Code section 104(a)(2). 1979-2 C.B. 74. This was because the plaintiff "had a right to receive only the monthly payments and did not have the actual or constructive receipt or the economic benefit of the lump sum amount" that was invested by the defendant to yield that monthly payment. *Id.,* at 74. The Service reasoned that the plaintiff "had no right to the discounted present value of the monthly income (the discounted value of which, at date of settlement, was less than the total monthly payments to be provided) or to control the investment of that amount." *Id.* The defendant possessed the ownership rights in the annuity, including the right to change the beneficiary.

By contrast, the I.R.S. stated in Rev. Rul. 79-220, "if a lump-sum damage payment is invested for the benefit of a claimant who has actual or constructive receipt or the economic benefit of the lump-sum payment, only the lump sum payment is treated as damages within the meaning of section 104(a)(2) of the Code." *Id.,* at 75.

In the case at hand, the defendant's tort liability has been extinguished in exchange for the defendant's agreement to pay the lump sum, and he has gone home. There is nothing left to settle. The lump sum has come to rest under the effective control of the claimant. The claimant is deciding by himself where the funds are to be invested. The funds are in the claimant's control, the same as if he or she had received a lump sum settlement.

In this situation, it has been the longstanding published position of the I.R.S. that the claimant has realized the economic benefit of the lump sum payment of damages and is subject to tax on the earnings from the investment of such lump sum. *See, e.g.,* Rev. Rul. 83-25, 1983-1 C.B. 116 in which the I.R.S. held that the claimant "will be treated as the owner of a trust created for the minor's benefit by court order as a result of a personal injury suit filed on the [claimant's] behalf." *Id.,* at 117. Under court order, the lump sum damage payment was made into the registry of the court and was then transferred to a trust for the benefit of the claimant, with the court designating a corporate trustee. There, as the approach of the proposed legislation, there were no competing interests in the trust proceeds, and all of the interests merged in the claimant. Similarly, in Rev. Rul. 76-133, 1976-1 C.B. 34, the claimant was held taxable on the earnings from a lump sum payment of damages that was "paid into the registry of the court for the sole use and benefit of the taxpayer" and thereafter was transmitted by the court clerk to a savings institution in the name of the taxpayer for deposit in a certificate of deposit.

Evidently recognizing this Federal tax risk to the injury victim, the proposed legislation seeks to will it away by providing that "[a]ny tax benefits existing on the effective date of this section shall be continued in full force and effect as if the provisions of this section had not been enacted." (Prop. Sec. 5-1702-A(D)). The U.S. Internal Revenue Service is unlikely to view itself bound by such a pronouncement.

The Proposed Legislation Upsets the Balance at the Settlement Table by
Mandating Compensation of Brokers Regardless of Work on the Settlement

Under the proposed legislation, if an agreement is not reached between the two sides on apportionment of the brokerage commission on the sale of the annuity to fund the structured settlement, the bill mandates that the defense broker and the plaintiff broker each be paid half of the commission. This mandate is wholly without regard to the amount of work done by the broker and his or her relative contribution to settlement of the case.

Under current longstanding structured settlement practice, the brokers for the two sides and their clients typically negotiate a split of the commission based on the particular circumstances of the case, including who contributed what to resolution of the case and the scope of efforts undertaken by each broker. The proposed legislation would upset this balance at the settlement table by effectively mandating that the plaintiff broker (and the defense broker) are each entitled to a minimum of half of the commission without regard to the level of work or role in achieving settlement.

This matter of the parties' compensation of their broker representatives is best left to be resolved by the parties themselves and should not have an arbitrary, "one-size-fits-all" result dictated by legislation.

Conclusion

The National Structured Settlements Trade Association strongly opposes A3786 and S4306. The proposed legislation would upset the settlement negotiation process that has been so successful in enabling the parties to resolve a tort or worker's compensation claim with the long-term financial security of a structured settlement for the injured claimant and his or her family.

If the proposed legislation is interpreted to mean that after the settlement agreement is finalized, the plaintiff would have the unilateral ability to impose the funding source on the defendant without regard to cost, thereby effectively dictating the cost of the settlement to the defendant, the defendant will have little interest in participating in the structured settlement in the first instance. If instead the provision means that the defense simply turns control of the lump sum of cash to fund the structured settlement over the plaintiff who then picks the funding source, Federal tax risks would be created for the plaintiff.

For more information, contact:

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