Structured Settlements™

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Single-Claimant QSF Guidance Exists

Courts Have Said No Economic Benefit if Future Event Must Occur

The U.S. Treasury Department and the IRS are committed to issue published guidance on the use of qualified settlement funds (QSFs) to do structured settlements with single claimants. However, the outcome of that guidance can only be favorable to the payees because, if a QSF is established to "resolve or satisfy" the claim or claims that were or could have been asserted against the original defendants or their insurers, as the Internal Revenue Code and Treasury Regulations require, the claimants cannot be deemed to have economic benefit.

QSFs were originally used, at the initiative of defendants, to settle mass tort claims. When plaintiffs began requesting courts to create them for cases with smaller numbers of claimants, some opponents came up with the canard that economic benefit occurs if there is a single claimant or if there is already an allocation among multiple claimants. Economic benefit would mean that the intended payee loses the tax breaks offered by a structured settlement. This ploy was designed to disturb plaintiffs and their attorneys into foregoing the use of QSFs for those cases.

The Internal Revenue Service official responsible for ruling on QSF issues recently confirmed that, under existing guidance, the economic benefit theory is not true. Jeffery G. Mitchell, a branch chief in the IRS's Income Tax & Accounting Division, on March 9, 2006, said to attendees at a seminar in Washington, D.C., sponsored by the Society of Settlement Planners (SSP), that the test found in *Sproull v. Commissioner*, 16 T.C. 244, 247 (1951), *aff'd*., 194 F.2d 541 (6th Cir. 1952), and refining case law can be relied on for determining whether an individual has economic benefit in the assets of a QSF. Mitchell's branch has been assigned to issue rulings on Internal Revenue Code § 468B, which is the basis for QSFs, also known as "468B Trusts." Mitchell confirmed that economic benefit does not automatically occur simply because a QSF is established ultimately for the benefit of a single plaintiff. Each case is subject to a review of facts and circumstances.

Economic Benefit Doctrine

In *United States v. Drescher*, 179 F.2d 863 (2d Cir. 1950), *cert. denied*, 340 U.S. 821 (1950), the employee received economic benefit of an annuity contract purchased by his employer in the year such contract was delivered to him, even though the contract was non-assignable.

Sproull, supra, became the seminal case to define the economic benefit doctrine when there was no constructive receipt, taxing amounts an employer paid to an interest-bearing trust as compensation for an employee's past services. No one other than the employee had any interest in or control over the monies in the trust, and the employee was required to take no further action to earn or establish his rights to the amounts in trust. The trustee's duties were limited to holding, investing, and paying the amounts in trust to the employee or his estate in the event of his prior death in the two taxable years following the creation of the trust. The Tax Court held that "there is no doubt that such an interest had a value equivalent to the amount paid over for his benefit." The court noted that "the trust agreement contained no restriction whatsoever on petitioner's right to assign or otherwise dispose of the interest thus created in him."

The economic benefit doctrine normally involves situations in which a cash method taxpayer elects to defer income he has a right to receive by arranging to have the money deposited in a third-party account. To account properly for such situations, courts developed the doctrine, beginning with *Sproull*, to require the inclusion in income of such amounts for the taxable period in which the fund was created. The economic benefit doctrine requires a cash method taxpayer to include in gross income items not actually received during the reporting period when the *Sproull* elements are present. Every court that has subsequently faced the question of whether the economic benefit doctrine applied to a particular situation has echoed these conditions of the Sproull trust, as restated in *Thomas v. U.S.*, 45 F. Supp.2d 618, 620 (1999), *aff'd*., 213 F.3d 927 (6th Cir. Ohio 2000) (citations omitted), quoting:

(1) There must be some fund in which money or property has been placed;

(2) The fund must be irrevocable and beyond the reach of the creditors of the party who transferred the funds to the escrow or trust; and

(3) The beneficiary must have vested rights to the money, with receipt conditioned only on the passage of time.

Other courts have followed that a taxpayer may still have an economic benefit in a trust even though there are restrictions on assignment. Some rulings have favored the taxpayer, going against the IRS. One IRS position favors taxpayers.

It was held in *Drysdale v. Commissioner*, 277 F.2d 413 (6th Cir. 1960), for example, that the economic benefit doctrine does not apply where the beneficiary's ability to obtain trust amounts is subject to a future condition or forfeiture. Drysdale, the taxpayer, was found not to have economic benefit of funds placed in trust by the employer where the use of those funds was conditioned upon his death, his reaching the age of 65, or his retirement from full time activity.

In *Minor v. United States*, 772 F.2d 1472 (9th Cir. 1985), the taxpayer did not have economic benefit in funds placed in trust under a deferred compensation agreement where the funds were conditioned upon limiting his practice after retirement and not competing with his present employer. The *Minor* court ruled there is no economic benefit when the beneficiary's right to receive the income is restricted or conditioned upon future events. The opinion in *Reed v. Commissioner*, 723, F.2d 138, 147 (1st Cir. 1983), held that economic benefit for a cash basis taxpayer requires that taxpayer's contractual right to future payment be evidenced by an instrument which is not only nonforfeitable but also readily assignable. A QSF requires a future event before anyone has a right to receive any amount from it, and certainly provides no evidence of a nonforfeitable and assignable contractual right.

The IRS has also argued against eco-

nomic benefit applying and prevailed. In *Thomas, supra*, husband and wife taxpayers had won a lottery in December 1992 and wanted economic benefit to apply in that year, as the 20 percent tax rate was due for an increase to 28 percent in 1993. The lottery funds were placed in a distinct fund pending verification of the lottery ticket, but were not in irrevocable trusts maintained exclusively for the benefit of prizewinners. The award was also subject to a future event—verification of the winning ticket. The IRS took the position, and the court agreed, that the lottery funds did not meet the technical requirements of the economic benefit doctrine in 1992. Thus, the IRS argued, the couple should be taxed in 1993 when the lottery jackpot was actually paid to the winners. This ruling favors single claimants of QSFs.

The IRS summarized the currently evolved test in Private Ruling 200138006:

"[I]n order for a taxpayer to include an amount in income under the economic benefit doctrine, the amount must be set aside irrevocably, for the taxpayer's sole benefit, without restrictions or conditions based upon the occurrence of future events."

Motive for the Myth

Some liability insurers allegedly profit from structured settlements through tortious and illegal practices such as misrepresentation of the true present value of the periodic payments and undisclosed rebating or reduced-commission arrangements with the annuity producers in exchange for the producer being selected. *See, for example, Macomber v. Travelers Prop. and Cas. Corp., et al.*, 804 A.2d 180 (Conn. 2002) (the "short-changing" and "rebating" schemes alleged have given rise to causes of action for fraud, negligent misrepresentation, breach of contract, unjust enrichment, civil conspiracy, and violations of state unfair trade practices and unfair insurance practices statutes). Not all liability insurers and defendants engage in these practices.

The National Association of Insurance Commissioners (NAIC), in a communiqué to state insurance regulators in December 2004, defined "Inappropriate Solicitation Activities" as practices whereby an insurance producer: "... (c) engages in activity that otherwise may be known as or understood to be 'bid-rigging' or inappropriate steering of business which is contrary to the interests of the client/consumer." Some liability insurers having affiliated life insurance companies allegedly steer the highly profitable annuity business to the life insurance company, denying the payee the benefit of free market competition.

The annuity producers selected by the defendants or their insurers, often to the exclusion of an annuity producer selected by the claimant, receive the undisclosed commissions built into the annuity's cost, which are arguably part of the claimant's recovery, as are attorney fees.

A QSF meets the requirements of Treas. Reg. (26 C.F.R.) § 1.468B-1(c) if it is established by any governmental authority (including a court of law) and is subject to its continuing jurisdiction; 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, giving rise to at least one claim asserting liability arising, among other things, out of a tort or breach of contract; and is a trust under applicable state law, or its assets are otherwise segregated from other assets of the transferor and related persons. IRS rulings consistently hold that there are no other requirements, including justification, for establishing a QSF.

When a QSF is established, the defendants and their insurers are released and dismissed from any lawsuit, the payor receiving a tax deduction under I.R.C. § 461 (h). The QSF, under governmental authority supervision and with an independent administrator, may allow the claimant to select the annuity producer and annuity issuer. Neither the defendant nor its insurer has any say in an annuity transaction between a QSF and a claimant.

Single Claimant Issue Contrived

The issue raised by those who want to see the use of QSFs by plaintiffs curtailed is whether a QSF established for the benefit of a single claimant can enter into an agreement with that claimant to make periodic payments, then make a "qualified assignment" of the obligation to a third party under section 130 of the Internal Revenue Code (26 U.S.C. § 130). As long as the promised payments are excluded from the payee's gross income under section 104(a)(2) for personal physical injury or physical sickness, the obligation may be assigned, unless the claimant or payee has constructive receipt or economic benefit of the funding asset or the money to purchase it. *See* S. Rep. No. 97-646, at 4 (1982). The ability to assign the obligation, if the funding asset is an annuity or obligation of the United States, allows the payee to receive not only the original amount tax-free but also the growth while the asset is held by the assignee.

Code section 130 requires that a "qualified assignment" must be made by the "person who is a party to the suit or agreement." That used to refer only to the defendant or its liability insurer, which allowed the defendant or insurer to insist on handling the annuity placement. But, Revenue Procedure 93-34, 1993-2 C.B. 470, provides that a QSF described in Treasury Regulations (26 C.F.R.) § 1.468B-1(c)(2) will be considered "a party to the suit or agreement" for purposes of Code section 130, if certain requirements are satisfied. When a QSF receives the transfer of funds from the original defendant or its insurer, the QSF, in effect, becomes a substitute defendant to "resolve or satisfy one or more contested or uncontested claims."

Constructive receipt is a doctrine holding that income is "constructively received" by a cash-basis taxpayer when it is set apart for him or otherwise made available so that he may draw upon it any time, without substantial limitations or restrictions. *See* 26 U.S.C. § 451; 26 C.F.R. § 1.451-2(a). Under the doctrine of constructive receipt a taxpayer may not deliberately ignore income in the year it occurs and instead elect another year for which he will report it. Constructive receipt has not been raised as an issue in whether a single-claimant QSF can make a qualified assignment.

Although taxation of deferred compensation plans, including structured settlements, is generally analyzed under the constructive receipt doctrine, the concept of economic benefit, which is quite different from constructive receipt, provides an alternate method of determining when a taxpayer receives taxable benefits.

Lobbying by Insurers

In a letter dated June 19, 2003, the SSP requested through its counsel, Skadden, Arps, Slate, Meagher and Flom, that the Department of Treasury and the Internal Revenue Service issue guidance under section 130 of the Internal Revenue Code. Specifically, the SSP, which is a plaintiff advocacy nonprofit organization, requested guidance to clarify that the assignment of a liability to make periodic payments does not fail to be a "qualified assignment" under section 130 solely because the settlement proceeds are held temporarily in a QSF under Treas. Reg. § 1.468B-1(c) before the liability is assigned. Section 130 of the Code provides that, in the case of a "qualified assignment" of a liability to make periodic payments of damages on account of personal injury, the assignee may exclude from gross income the amount it receives for assuming the liability to the extent assets are acquired to fund the periodic payments.

This project first appeared on the Treasury and IRS Priority Guidance Plan on April 23, 2004, in a quarterly update, and remains on the "to-do" list. Mitchell explained that the delay has been due to diversions caused by the need for tax rulings on relief funds for natural disasters such as the recent hurricanes, floods and a tsunami, plus the departure of several key people from Treasury and the IRS.

Since that request was made, this question has become a politically charged matter. The defense interests have lobbied Treasury not to publish the requested guidance with the argument that increased use of the QSF will reduce the use of structured settlements. A letter, dated May 10, 2004, to senior Treasury and IRS offi-

cials from the National Structured Settlements Trade Association, said: "If the defense is unable to participate in a negotiation that seeks to match payments and needs on a cost efficient basis, the defense will have no stake in the process and will correspondingly lessen its interest in helping to promote the use of structured settlements."

IRS Has Already Ruled

While Treasury and the IRS are committed to issuing published guidance specifically on qualified assignments from QSFs, such guidance already exists for those who believe in the doctrine of *stare decisis*, which is the underpinning of our legal system. From the Latin "to stand by things decided," *stare decisis* is the "doctrine of precedent, under which it is necessary for a court to follow earlier judicial decisions when the same points arise again in litigation," according to Black's Law Dictionary, 7th Ed. (1999), 1414.

The IRS cited *Sproull* in Revenue Ruling 2003-115, issued as guidance for those opting for periodic payments from the September 11th Victim Compensation Fund of 2001. Revenue Ruling 2003-115 provides the necessary guidance for a structured settlement with a QSF established for the benefit of a single claimant:

"The economic benefit doctrine, developed in case law, provides that if a promise to pay an amount is funded and secured by the payor, and the payee is not required to do anything other than wait for the payments, an economic benefit is considered to have been conferred on the payee and the amount of such benefit is considered to have been received. In *Sproull*, the court found that an economic benefit had been conferred on a taxpayer when the taxpayer's employer established a trust to compensate the taxpayer for past services. In 1945, the employer transferred money to the trust to be paid to the taxpayer in 1946 and 1947. The taxpayer was the trust's sole beneficiary. The court held that the taxpayer received compensation in 1945 in an amount equal to the value of the amount transferred to the trust for the taxpayer's benefit because such transfer to the trust provided the taxpayer with an economic benefit.

"Not all rights to receive periodic payments, however, trigger application of the economic benefit doctrine. Rev. Rul. 79-220, 1979-2 C.B. 74, concludes that a right to receive certain periodic payments under the facts of the ruling does not confer an economic benefit on the recipient. In Rev. Rul. 79-220, a taxpayer entered into a settlement with an insurance company for the periodic payment of nontaxable damages for an agreed period. The taxpayer was given no immediate right to a lump sum amount and no control of the investment of the amount set aside to fund the insurance company's obligation. The insurance company funded its obligation with an annuity payable directly to the taxpayer. The insurance company, as owner of the annuity, had all rights to the annuity and the annuity was subject to the claims of the general creditors of the insurance company. The ruling concludes that all of the periodic payments are excluded from the taxpayer's gross income under § 104(a)(2) because the taxpayer did not receive, or have the economic benefit of, the lump sum amount used to fund the annuity. Further, the ruling holds that if the taxpayer dies before the end of the agreed period, the payments made to the taxpayer's estate under the settlement agreement are also excludable from the gross income of the estate under § 104(a)(2)."

There are many inherent characteristics of well-drafted QSF documents that prevent a single claimant from having economic benefit or constructive receipt in the QSF's assets. Essentially, as long as the QSF is established and operated according to Treasury Regulations to "resolve or satisfy" the claim or claims, there must be a future event (the settlement with the QSF), and that blocks the claimant from having economic benefit in the QSF's assets.

Whether the claimant has current economic benefit of the QSF assets depends on a facts and circumstances test. Economic benefit does not occur automatically solely because there is only one claimant. If there is no economic benefit or constructive receipt, the QSF may assign a periodic payment obligation under the provisions of section 130. To say otherwise goes against well-settled case law.

At a minimum, Treasury must recognize this when it issues its guidance. A ruling adverse to the taxpayer would be inconsistent with this case law and almost certain to be challenged. For Treasury to confirm that a single-claimant QSF is subject to the *Sproull* test will be a good result. No less favorable ruling is expected. An even better result would be for Treasury to adopt the common-sense approach to interpreting congressional intent used by the IRS in Private Ruling 97-03038, when it said that economic benefit was not applicable to a qualified assignment.

By comparison, a "qualified assignment" under section 130 contains all of the elements of *Sproull* that would cause the payee to have economic benefit of the "qualified asset" held by the assignee, and that has never been an issue. Under a qualified assignment, the amount is set aside irrevocably for the taxpayer's sole benefit, without restriction or condition based upon the occurrence of future events. Since 1988 (TAMRA), the payee additionally can be given a security interest in the annuity contract, putting the payee ahead of general creditors. Since 2002, the payee has a right under section 5891 to sell future payments, with advance written approval from a state court. If the *Sproull* test were applied, every qualified assignment would fail.

The IRS acknowledged in Private Ruling 97-03038 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 payments." Nothing in the legislation or its history spelled out congressional intent, but it was obvious to the IRS that economic benefit was never meant to be applied to a qualified assignment. It should be even more obvious with the QSF.

In a QSF, unlike a qualified assignment, the claimant has absolutely no rights to the QSF's assets until there is an agreement between the QSF and the claimant. Further, the QSF's assets are subject to any unforeseeable claims by other claimants not immediately identified, but who could emerge. Inasmuch as a QSF must be established to "resolve or satisfy" a claim or claims, in order to meet the conditions of a QSF, by definition the claimant is restricted from having any benefit until the occurrence of a future event—a settlement with the QSF to give up the claim against it. As long as a QSF is established to meet the definition in Treas. Reg. § 1.468B-1(c)(2), "to resolve or satisfy" a claim or claims, and operates that way, the claimant does not have economic benefit.

It is inconsistent for opponents of QSFs to raise the economic benefit argument for single-claimant QSFs, where the law is well settled, and ignore the qualified assignment scenario, where economic benefit is avoided only because the IRS believes it was never intended by Congress that injury victims should lose their tax benefits for this reason.

Treasury or the IRS justifiably could take the same position with single-claimant QSFs that the IRS took with qualified assignments, declaring that economic benefit universally does not apply to a QSF. By definition, because a QSF must "satisfy or resolve" the claim or claims, there is a future event that prevents economic benefit from occurring. Blanket treatment would be more justified for a QSF than the IRS position on qualified assignments. Such position might allow the use of standardized or uniform documents, as when making a qualified assignment. Whether a QSF remains subject to a facts and circumstances test al la *Sproull* or is exempted by a blanket ruling that economic benefit does not apply, the result will be a good one for the taxpayer.

While the anticipated published ruling specific to the QSF will dispel the myth, there is no reason for a single claimant to avoid a QSF, because precedent already exists in court decisions. *Stare decisis!* ■

Can Punitive Damages Be Compromised?

The awarding of punitive damages by a jury in a physical injury case can be a double-edge sword to the plaintiff. There is satisfaction that the tortfeasor is being punished for egregious behavior, but the tax burden on the plaintiff that goes with punitive damages can be draconian, especially if the alternative minimum tax (AMT) is applied.

What happens to punitive damages in a physical injury case when the opposing parties enter into a compromise settlement agreement in lieu of appealing the verdict? The answer is that definitive guidance is lacking, and that fact may provide an opportunity to mitigate the plaintiff's tax burden—even make it vanish.

Gross income, which determines how much a person will pay in income taxes, means all income from whatever source derived, except as otherwise provided in the Internal Revenue Code (IRC). 26 USC § 61(a). That would include damages from much litigation, a major exception being damages paid on account of personal physical injuries or physical sickness. In fact, until 1996, when P.L. 104-188 was enacted, all damages from any personal injury case, regardless of whether the injury was physical, were excluded from the taxpayer's gross income.

For many years, there was a question whether punitive damages awarded in personal injury cases were taxable. The Internal Revenue Service was inconsistent on this, and so were the courts. In 1958, the IRS ruled that punitive damages do not qualify for exclusion from the taxpayer's gross income under IRC § 104(a)(2). Rev. Rul. 58-418. The IRS reversed itself in 1975, declaring that punitive damages are excludable. Rev. Rul. 75-45. Then, in 1984, addressing the wrongful death statute in Alabama, where the only recovery is as punitive damages, the IRS again reversed itself, saying that punitive damages now were taxable. Rev. Rul. 84-108. In 1996, P.L. 104-188 made an exception for the Alabama wrongful death rule, codified at 26 USC § 104(c), that punitive damages in a wrongful death action are not taxable if the only award can be as punitive damages.

In 1995, the U.S. Supreme Court, in *O'Gilvie v. U.S.*., 95-2 U.S.T.C., ¶50,508, 66 F.3d 1550 (10th Cir. 1995), 519 U.S. 79 (1966), settled the lack of harmony among the courts, holding that punitive damages are taxable in personal injury cases. Congress essentially codified *O'Gilvie* in the Small Business Job Protection Act of 1996, P.L. 104-188, § 1605 (d), amending IRC § 104(a)(2) to insert parenthetically that gross income does not include damages (other than punitive damages) in a physical injury case, whether by suit or agreement and whether as lump sums or as periodic payments.

The public policy reason for taxing punitive damages, as stated in the legislative history, is: "Punitive damages are intended to punish the wrongdoer and do not compensate the claimant for lost wages or pain and suffering. Thus, they are a windfall to the taxpayer and appropriately should be included in taxable income." House Rpt. 104-586.

Contingent attorney fees paid for punitive damages, along with fees in certain other taxable damage cases such as defamation, false imprisonment, negligent infliction of emotional distress, abuse of legal process, property rights, insurance bad faith, invasion of privacy and contractual relations litigation, are taxed not only to the attorney but also first to the plaintiff. Even if the plaintiff never sees the money retained by the attorney as a contingent fee, the plaintiff pays taxes on it. There is no above-the-line deduction on the taxpayer's tax return for attorney fees in many taxable damage cases, including punitive damages.[1] Below-the-line deductions are subject to a two percent floor and a cap. If the AMT applies, there is no deduction at all.

The effect is exacerbated when the state can claim a portion of punitive damages under "split recovery" laws, as nine states currently do.[2] These laws vary as to percentage taken (50 to 75 percent), how the portion is applied, and whether attorney fees are included in the calculation. Mercifully, the IRS allows deduction of attorney fees allocable to a state's share of punitive damages. *See* IRS Chief Counsel Advice 200246003.

If the punitive damages are significantly larger than the compensatory damages in a physical injury case, it is conceivable that the plaintiff can owe money after income taxes and attorney fees are accounted for, keeping none of the recovery.

Many claims are resolved through a compromise settlement if a verdict adverse to the defendant is appealed. The question is whether punitive damages awarded at trial can be eliminated if the parties agree to set aside the verdict and agree to a compromise. The IRS has indicated its position in an audit-training guide that punitive damages cannot be eliminated.[3] Field agents are told that they should determine, for out-of-court settlements of physical injury cases, "if proper amounts were allocated between compensatory and punitive damages." This suggests that the ratio of taxable to nontaxable damages should be observed in a compromise settlement.

This approach seems both unreasonable and unsupportable. It is unreasonable because punitive damages are usually the first to be reduced or eliminated at the appellate level. Thus, a compromise of the total verdict should reasonably recognize what is most likely to be left is a higher proportion of compensatory damages.

The approach of even preserving punitive damages at all in a compromise is unsupportable because punitive damages, being governed by state law, are usually very specifically regulated. Punitive damages are awarded only through a statutorily prescribed civil procedure. Parties simply do not agree among themselves that one party will pay punitive damages to another. When a jury verdict is set aside by agreement of the parties, and the lawsuit is dismissed, it can be argued that the punitive damage award also goes away by operation of law. A compromise of a verdict, in lieu of appeal, is an arm's-length transaction, with valid reasons for both sides to eliminate punitive damages. The plaintiff wants to eliminate them for obvious tax reasons. Defendants want to eliminate them because of the stigma attached to them and since most insurance policies do not cover punitive damages. This is not merely an accommodation to one side.

Interpretation of tax law is resolved either in IRS rulings or in the courts. This tax issue is unresolved. No tax practitioner can guarantee that the IRS will not find some reason to challenge a tax return, so the objective in settlement planning is to control the risk to the plaintiff. A more aggressive approach can also mean greater risk of an audit and resulting adverse allocation.

The IRS has had some successes in asserting its positions on allocation of damages in general. In *Robinson v. Commissioner*, 102 T.C. 116 (1994), Tax Court held (and the Fifth Circuit subsequently affirmed) that the taxpayer's out of court settlement allocation be set aside for tax purposes because the negotiations were not conducted in an adversarial manner. The taxpayer was given the freedom to allocate as he wanted in order to minimize the tax effect. In *LeFleur v. Commissioner*, T.C. Memo. 1997-312, the IRS successfully reallocated $800,000.00 from then-nontaxable emotional distress[4] claims to taxable punitive damage claims.

The IRS does not always prevail in court challenges to its actions; there is no case on point; and this punitive damages issue seems to weigh in the taxpayer's favor. ■

Pursuant to Internal Revenue Service circular 230, we advise that this article is not intended as tax advice, nor is it to be used, and cannot be used, for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code or recommending any matter addressed herein.

1. The American Jobs Creation Act of 2004, P.L. 108-357, provides relief of double taxation of attorney fees, generally, in civil rights cases. See also *Commr. v. Banks*, 125 S. Ct. 1025 (2005).

2. The following states have adopted split recovery laws: Alaska, California, Georgia, Illinois, Indiana, Iowa, Missouri, Oregon and Utah. Source: American Bar Association *Litigation News*, Sept. 2005, Vol. 30, No. 6, p.5.

3. Market Segment Specialization Program: *Lawsuits, Awards and Settlements*, Dept. of the Treasury, IRS, Training 3123-009 (11-00), TPDS No. 86391G.

4. At the time, IRC § 104(a)(2) did not require "physical" injury or sickness for the recovery to be excluded from gross income.

Class Certification Reversed in *Macomber v. Travelers*

The Connecticut Supreme Court, on April 4, 2006, reversed the trial court's order certifying a class action and certifying the plaintiff as representative of the class in a lawsuit over an insurer's structured settlement practices. *See Macomber v. Travelers Property & Casualty Corp*., 277 Conn. 617 (2006).

Previously, the court had reinstated six of 10 substantive counts against the defendants in *Macomber v. Travelers Property & Casualty Corp.*, 804 A.2d 180 (2002). On remand, the plaintiff was granted class certification on four of the counts, including breach of contract, breach of the Connecticut Unfair Insurance Practices Act, which was merged into the Connecticut Unfair Trade Practices Act count, civil conspiracy and unjust enrichment. The defendants appealed.

"In general terms," the 2006 decision said, "the complaint alleged that the defendants, in utilizing structured settlements to resolve various types of personal injury claims, had engaged routinely in two types of wrongdoing: a rebating scheme; and a shortchanging scheme. The rebating scheme was based on the fact that, when the annuities underlying the structured settlements were purchased by Travelers Casualty through brokers, the brokers would rebate a portion of their commissions to Travelers Casualty. The shortchanging scheme was based on the fact that Travelers Casualty, by virtue of the rebating and other arrangements, would spend less on the annuities than the amounts called for in its agreements with the claimants."

The latest opinion by the Connecticut Supreme Court was critical of the trial court's handling of discovery. It noted that the trial court employed a truncated discovery process that was inadequate to determine important issues on the question of class certification.

In an attempt to accommodate the plaintiff's request for class discovery and the defendants' concerns about he potential production of thousands of claim files, the trial court randomly selected 28 sample files in addition to those of Macomber and a former plaintiff, Kathryn Huaman, for review. The record indicated that all of the sample files had been culled by the defendants to include only the documents pertinent to the motion for class certification. There was no agreement that the 30 files submitted to the court were materially representative of the thousands of files in which Travelers Casualty had entered into structured settlements in the years in question.

The major issue on remand is whether it can be established by sampling that the nationally dispersed potential class members entered their structured settlements by being told uniformly by claims adjusters and other agents of the defendants the cost of their annuities and that the value equaled the cost. Discovery will also need to determine whether Connecticut law conflicts with the state laws of the various members of the potential class. The ruling gives the plaintiff the "opportunity to establish the requisite predominance of common factual issues of an adequate record, if she chooses to do so on the remand."

The ruling also said the class representative plaintiff has no standing to raise a claim against defendant Solomon Smith Barney Holdings, Inc., because she had no dealings with them. Therefore, she "does not have the requisite typicality to raise the same claim on behalf of a class." ■

Hartford Class Action Suit Filed on Structure Practices

A class action lawsuit was filed against Hartford Financial Services Group, Inc., and several subsidiaries in U. S. District Court, District of Connecticut, *Spencer, et al. v. Hartford Financial Services Group, et al*., No. 3:05CV1681.

The original complaint was filed October 31, 2005, by Oshonya Spencer, an Ohio resident; Charles Strickland, a Pennsylvania resident; and Douglas McDuffie, an Oklahoma resident, on behalf of themselves and all others similarly situated. Each settled with a Hartford property and casualty company for injuries sustained in separate vehicle accidents, all three settlements involving periodic payments funded by annuities issued by Hartford Life Insurance Company.

Claims for relief by the proposed class or a sub-class against one or more of the defendants generally include: breach of contract, violation of the federal Racketeer Influenced Corrupt Organization Act (RICO), common law fraud, civil conspiracy/aiding and abetting, unjust enrichment and constructive trust.

Plaintiffs allege that, in every case, the claims representative or the structured settlement "broker" or both represented the total cost of the settlement to them, including a specified amount that was to be fully invested in the periodic payments. In every case, according to the complaint, Hartford received the benefit of the commission secretly bundled into the premium or cost of the annuity, either by avoiding the cost of hiring the structured settlement broker or retaining all or part of this amount for themselves. That caused each settling plaintiff to receive less than the amount agreed on to fund the future payments.

This alleged short-changing scheme is said in the complaint to be conducted by Hartford entities plus six outside brokerage companies and several "Doe" outside brokers, forming an association-in-fact to engage in racketeering activity. No broker is named as a defendant.

Hartford responded with a motion to dismiss. The insurer denies wrongdoing and claims that the parent company is the wrong defendant. It also maintains that the breach of contract claim is without merit because, among other things, as to two of the named plaintiffs, it is based upon alleged statements and/or representations concerning the cost of those plaintiffs' annuities that are not contained in plaintiffs' fully integrated settlement agreements. Hartford also contends, among other defenses, that the RICO claim failed to allege sufficiently the existence of a RICO enterprise.

Following the decision of the Connecticut Supreme Court in *Macomber v. Travelers Property & Casualty Corp*., 277 Conn. 617 (2006), the plaintiffs filed an amended complaint on May 1, 2006, which, among other things, adds Hartford Life, Inc., Hartford Life Insurance Company, Hartford Accident and Indemnity Company, Hartford Casualty Insurance Company, Hartford Insurance Company of the Midwest and Hartford Fire Insurance Company. ■

SSI and Medicaid Benefits Not Lost after Reaching 65

Annuity payments from a structured settlement may continue to be made into a special needs trust established for the benefit of a disabled individual under section 1917(d)(4)(A) of the Social Security Act [42 U.S.C. § 1396p(d)(4)(A)] after the beneficiary reaches age 65 without loss of Supplemental Security Income (SSI) or Medicaid. Nancy Veillon, associate commissioner of the U.S. Social Security Administration for Income Security Programs, responding to a request from attorney Jay J. Sangerman of New York, N.Y., wrote on January 31, 2006: "CMS [The Center for Medicare & Medicaid Services] has taken the position that additions to the trust made after the individual reaches age 65 should not be treated differently from prior additions where there has been an irrevocable assignment of the structured settlement to a properly established SNT." Generally, a person eligible for SSI is also eligible for Medicaid. ■

MetLife Acquires Travelers

Metropolitan Life Insurance Company acquired The Travelers Insurance Company and The Travelers Life and Annuity Company from Citigroup, Inc., on July 1, 2005. Effective May 1, 2006, Travelers Insurance became MetLife Insurance Company of Connecticut and Travelers Life and Annuity became MetLife Life and Annuity Company of Connecticut.

According to a company announcement, the name change will not affect the provisions of any contracts or reinsurance agreements with Travelers. ■

Major Annuity Markets Available to Settlement Specialists

Life Insurance Company *Assignment Company* *GUARANTOR*	A.M. Best		Standard & Poor's	Moody's Investor Services	Fitch	FEATURES *Current and believed to be accurate as of May 15, 2006. Verify independently before reliance.*
Allstate Life Insurance Co **Allstate Life Ins Co of NY** *Allstate Assignment Company* *Non-Qualified Assigned Ben Co*	A+ A+	XV IX	AA+ AA+	Aa2 Aa2	N/R N/R	$10,000 minimum premium; $250 assignment fee by AAC, $500 assignment fee by NABCO; daily rates; assigned attorney fees thru NABCO; rated ages; commutation rider at no additional cost; assignee is shell company; corporate guarantee; non-qualified assignments of taxable and non-taxable payments through NABCO
American General Life Ins Co **AI Life Assurance Co of NY** *American Gen Annuity Svc Corp* *American Home Assurance Co* *AMERICAN GENERAL CORP LIC*	A+ A+ A+ A+	XV XV XV XV	AA+ AA+ AA+	Aa1 Aa1 Aa2	AA+ AA+ AA+	$10,000 minimum premium; $500 assignment fee; daily rates; assigned attorney fees; cash refund option; rated ages; single lump sum; AGASC is shell company with corporate guarantee from American Gen. Corp LIC.; AHAC (a P&C company with different rating criteria) is obligor for AILACNY; secured creditor status; reinsurance indemnity agreement; commutation at no additional charge
Aviva Life Ins Co **Aviva Life Ins Co of New York** *Aviva Assignment Corp* *Aviva London Assignment Corp* CGU INT'L INS PLC	A+ A+ A+	IX VI XV	N/R N/R AA-	N/R N/R Aa2	A+ A+ AA-	(Formerly CGU) $5,000 minimum premium; $400 assignment fee; daily rates; cash refund option; rated ages; assignee is shell company; reinsurance indemnity agreement; assigned attorney fees, including stand-alone; single-claimant QSF; commutation rider available at no additional cost; Capital Maintenance Agreement from CGUII on cases assigned to Aviva London Assignment Corp for $500 assign fee.
First Colony Life Ins Co **American Mayflower Life Ins Co** *Jamestown Life Ins Co* *Mayflower Assignment Corp*	A+ A+	XV XV	AA- AA-	Aa3 Aa3	N/R N/R	$5,000 minimum premium; $500 assignment fee; daily rates over $250,000; cash refund option; secured creditor status; rated age; assigned attorney fees; assignee of FCL cases (Jamestown) is separate life insurance company; assignee of AML (New York) cases is shell company (Mayflower), guaranteed by FCL (or AML by request); reinsurance indemnity agreement
Genworth Life Insurance Co **Genworth Life Ins Co of NY** *Assigned Settlement Inc*	A+ A+	XV XV	AA- AA-	Aa3 Aa3	N/R N/R	$5,000 minimum premium; $500 assignment fee; daily rates over $250,000; cash refund option; secured creditor status; rated age; assigned attorney fees; reinsurance indemnity agreement
Hartford Life Insurance Co *Hartford CEBSCO*	A+	XV	AA	Aa3	AA+	$10,000 minimum premium; $300 policy fee under $50,000; no assignment fee; daily rates; secured creditor status; rated ages; assigned attorney fees; single lump sum; cash refund option; commutation rider at no additional cost; assignee is shell company
John Hancock Life Ins Co *John Hancock Assignment Co*	A++	XV	AA+	Aa3	AA	$10,000 min premium (incl assignment fee); $500 assignment fee; $250 policy fee under $25,000 or amt required to bring to $25,000; daily rates over $100,000; assignee is shell company; life company guarantees obligations; single-claimant QSF; rated ages; stand-alone and jt & surv atty fees; commutation rider at no add'l cost; cash refund option; licensed in N.Y.; approval req'd for sales over $1 million
Liberty Life Assur Co of Boston *Employers Insurance of Wausau* *BARCO Assignments, Ltd.* LIBERTY MUTUAL	A- A A	VIII XV XV	A A A	A1 A2 A2	N/R N/R N/R	No minimum premium; $400 policy fee under $25,000; $300 assignment fee; daily rates over $200,000; cash refund option; single lump sum; assignee is a separate company; corporate guarantee from Liberty Mutual; rated age; non-qualified assignment of taxable and non-taxable payments accepted by BARCO; commutation rider at no additional cost.
Massachusetts Mutual LIC *MassMutual Assignment Co* MASSACHUSETTS MUTUAL LIC	A++ A++	XV XV	AAA AAA	Aa1 Aa1	AAA AAA	$10,000 minimum premium; $500 policy fee under $25,000 or amount required to bring the case to $25,000; no assignment fee; daily rates over $200,000; commutation rider available at no additional cost; secured creditor status; rated age; assignee is shell company with corporate guarantee from MassMutual LIC; guarantor assets of $396 billion as of 12/31/2005; licensed in New York and Puerto Rico.
Metropolitan Life Ins Co *MetLife Tower Resources Gp, Inc.*	A+	XV	AA	Aa2	AA+	No minimum premium; $1,000 policy fee under $5,000, $300 under $20,000; $750 assignment fee; daily rates over $100,000; cash refund option; single lump sum; secured creditor status; assigned attorney fees; offers variable annuity. Effective May 1, 2006, Travelers Ins became MetLife Ins Co of Conn and Travelers Life and Annuity became MetLife Life and Ann Co of Conn.
New York Life Ins Co *New York Life Ins & Annuity Corp*	A++ A++	XV XV	AA+ AA+	Aa1 Aa1	AAA AAA	$10,000 minimum premium; $750 assignment fee; daily rates over $750,000; rated age; commutation rider; assigned attorney fees; assignee is separate life insurance company; NYL guarantees the performance of NYLIAC
Pacific Life and Annuity Co *Pacific Life & Annuity Svcs, Inc* PACIFIC LIFECORP	A++	XV	AA	Aa3	AA	$20,000 minimum premium; $250 assignment fee; $500 small case fee under $25,000; daily rates; installment and cash refund if non-assigned; rated ages; secured creditor; commutation riders; up to 300% J&S; NY licensed; attorney fee assignment; no stand-alone attorney fees; assignee is shell company, guaranteed by Pacific LifeCorp, a stock holding company
Prudential Ins Co of America *Prudential Assigned Sett Svcs Corp*	A+	XV	A+	Aa3	AA-	$5,000 minimum premium; $250 assignment fee; daily rates over $250,000; assigned attorney fees; secured creditor status; rated age; assignee PASSCorp is shell company, guaranteed by Prudential; approval required for sales over $1 million
Symetra Life Insurance Co *Symetra Assigned Benefit Co* *Symetra Nat'l (Workers Comp)* SYMETRA LIFE INSURANCE CO	A A	XII XII	BBB+ BBB+	A2 A2	A+ A+	(Formerly SAFECO) $5,000 minimum premium; $300 policy fee under $10,000; $500 assignment fee; daily rates available; commutation rider; single lump sum; assigned attorney fees; secured creditor status; rated age; assignee SABCO is shell company, guaranteed by Symetra Life Insurance Co; nonqualified assignment to Symetra National Life for pre-§ 130 workers' comp claims

Structured Settlements

America's Most Socially Responsible Method of Indemnification

Structured settlements are encouraged by Congress, as public policy, because of the protection they provide to physical injury victims

- Qualifying payments for physical injury, physical sickness or workers' comp are federal and state income tax-free
- Taxable payments—including attorney fees—may be deferred
- Settlement proceeds cannot be dissipated
- Benefits can be tailored to meet claimant's individual needs
- Payments can be increased to help keep pace with inflation
- Fixed-size payments are guaranteed by one of our economy's strongest sectors
- No investment worries—you are insulated from the market
- Claimants will never outlive income when lifetime periodic payments are selected
- Periodic payments may survive bankruptcy
- Payments may be pledged if needs change, if court approves

A structured settlement for workers' compensation or physical injury tort claims is made possible by a special provision in the United States Internal Revenue Code that **excludes all payments** except for punitive damages from current year income taxation, whether received as a lump sum or in periodic payments.

If the entire settlement is taken as a cash lump sum, that amount is excluded from current year taxable income, but **the first dollar earned on the award becomes a taxable event**. The growth from an investment will be subject to federal and state income taxes, which reduces the net performance of the investment by the marginal tax rates, which can approach 50 percent.

Conversely, in a structured settlement of tax-excluded damages, the annuity's earnings remain tax free. The structured payments must be determined at the time of settlement and incorporated into the settlement agreement and release, not afterwards when it is too late. **Once the cash is either actually or constructively received by the claimant, the benefit of tax-free growth is lost forever.**

Despite best intentions, lump sum payments are dissipated within a short time after the money is received by the claimant. **It is believed that 90 percent of cash settlements are gone within five years.** Tragically, when the money is intended to replace lost income for a disability or to care for a seriously injured or ill individual for a lifetime, that person may be left without the means of self-support or to receive appropriate care.

Taxable payments, such as punitive damages, breach of contract damages, emotional distress, and the like, may be deferred like a non-qualified deferred compensation plan. **Attorney fees** can be deferred as a private, discriminatory retirement plan.

Following are edited, abbreviated descriptions of the rating services. Complete explanations are available from the rating companies or through a reference library. Information on this chart is believed to be accurate, as of the date shown, compiled from several sources. However, publisher recommends verification of chart and explanations before reliance.

A.M. Best Company — Most frequently used reference for evaluating the financial strength of insurance companies that either finance periodic payments or serve as periodic payment obligors. Rating system has two components: an alphabetical system to describe the relative financial strength, and a (roman) numerical system to describe financial size. Letter ratings can be modified by a set of suffixes. Six new letter ratings were added in 1992. A++ and A+ (Superior) *"have a very strong ability to meet their policyholder and other contractual obligations over a long period of time."* A and A- (Excellent) *"have a strong ability to meet their policyholder and other contractual obligations over a long period of time."* Financial size categories range from I, the smallest, with up to $1 million of reported policyholders' surplus plus conditional reserve funds, to XV, with more than $2 billion. Ratings: A++ and A+ (Superior); A and A- (Excellent); B++ and B+ (Very Good); B and B- (Good); C++ and C+ (Fair); C and C- (Marginal); D (Below Minimum Standards).Rating modifiers: q=qualified rating; x=revised rating; w=rating watch list. (Ratings of property and casualty companies employ different criteria.)

Standard & Poor's Corporation — Rates operating insurance companies for financial strength. Profile is uniform for all types of insurance companies and covers: industry risk, management and corporate strategy, business review, operational analysis, capitalization, and financial flexibility. Ratings: AAA, AA, A, BBB, BB, B, CCC, CC or C, D. Rating modifier: pi=rating based on public information.

Moody's Investor Service — Began rating insurance companies for their ability to meet policyholder obligations and claims in the early 1980s. "Insurance claims paying ratings" were applied to insurance companies offering guaranteed investment contracts beginning in 1987. Rating of Baa or higher is considered to be "investment grade." Ratings: Aaa, Aa, A, Baa, Ba, B, Caa, Ca, C.

Fitch (formerly Duff and Phelps) — First entered the business of issuing claims-paying ability ratings on insurance companies in 1986. They issue four types of ratings on insurance companies: fixed income (bonds and preferred stock), commercial paper, structured finance, and claims paying ability (shown in this chart). Ratings: AAA (Highest claims paying ability); AA+, AA, AA- (Very high); A+, A, A- (High); BBB+, BBB, BBB- (Below average); BB+, BB, BB- (Uncertain); B+, B, B- (Possessing risk); CCC (Substantial risk).

In addition to ratings, other factors such as secondary guarantees by non-insurance company guarantors also should be considered.

U.S. Supreme Court Bars Medicaid from Collecting Non-Medical Proceeds

The U.S. Supreme Court ruled on May 1, 2006, that a state's Medicaid department may not demand reimbursement from portions of a settlement intended to cover non-medical damages.

In *Arkansas Dept. of Human Servs. v. Ahlborn*, 547 U.S. ___ (2006), the Supreme Court affirmed (No. 04-1506) the Court of Appeals for the Eighth Circuit, *Ahlborn v. Arkansas Dept. of Human Servs*., 397 F.3d 620 (2005), which had reversed the U.S. District Court (E.D. Ark.), holding that an Arkansas statutory lien on a tort settlement following payment of Medicaid, equal to Medicaid's costs, contravened federal law and was therefore unenforceable.

Arkansas state law had imposed a lien on all settlement proceeds, including those meant to compensate the recipient for damages distinct from medical costs—like pain and suffering, lost wages and loss of future earnings.

Heidi Ahlborn's settlement with the third-party tortfeasors did not allocate between categories of damages. Her claim was valued at $3,040,708.18. She recovered only $550,000 in an out-of-court settlement. Arkansas DHS had asserted a lien to recover its outlay of $215,645.30. It had stipulated that only $35,581.47 was compensation for medical expenses, which is what it ultimately received.

Settling parties should allocate medical costs when a Medicaid lien is a factor.

The Supreme Court had granted *certiorari* to resolve a conflict with previous rulings in other courts that had upheld similar state lien provisions. See, *e.g*., *Houghton v. Dept of Health*, 57 P.3d 1067 (Utah 2002), and *Wilson v. Washington*, 10 P.3d 1061 (Wash. 2000) (*en banc*). ■

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