Making settlements last a lifetime

An updated look at structured settlements versus cash payouts to plaintiffs

By Patrick Farber and Enrique Sierra

As attorneys negotiate settlements in personal injury cases, injured clients must decide whether to take the settlement funds in a lump sum or a combination of a lump sum and a structured settlement annuity. Deciding what to do with a settlement payout is often foreign territory for those who have never had to manage such large sums of money. How will it be invested?

According to the National Structured Settlement Trade Association, "only about one-third of the injured persons who are offered a structured settlement choose one (with the other two-thirds taking a cash lump sum)." That means two-thirds believe they can make the necessary financial decisions that will be sufficient in both the short and long term.

Who is most likely to take a structured settlement

Individuals who are seriously injured and need a lifetime of round-the-clock care are not inclined to use their settlement funds to buy fancy cars or to take long, exotic vacations. These clients are much more likely to select the structured settlement route – where funds are designated and dispersed for medical and living costs throughout their lives.

Those who are injured but recover completely or can return to near-normal lives seem to have the most difficult time holding on to settlement money. Human nature being what it is, whether a young professional athlete with a huge salary, a lottery winner or a person who receives a large personal injury settlement, those who come into money quickly seem to lose it almost as fast.

Take for example, former NFL player Clinton Portis who made $40 million during his nine-year career. He filed bankruptcy at age 34 – five years after his playing days ended. He's one of countless former professional athletes who lost all their earnings shortly after retiring. Many lottery winners don't fare much better. Tales of bankruptcies and divorce often follow million-dollar winnings.

Settlement fund recipients are also at risk of losing everything. Though statistics are hard to come by, an insurance report from The Rutter Group shows "that 25 to 30 percent of all accident victims completely dissipate their judgments or settlements within two months of recovery and 90 percent spend it all within five years." (Source: the Rutter Group, Ltd from

Flahavan, Rea, Kelly & Tener, "California Practice Guide: personal injury" (trg 1992) ch. 4).

Common reasons why individuals quickly lose their settlement (or huge sports salaries or lottery winnings) are: they listen to (and take) bad financial advice, trust untrustworthy "friends" and relatives with their money and lack the discipline and knowledge to make informed decisions about their current and future financial needs.

A financial balance

Imagine how frustrating for all parties if the plaintiff receives a fair settlement only to see it disappear because of unsound investment decisions, giving in to spending temptations or succumbing to pressure to give handouts to family and friends.

A balanced approach is often the best approach – clients receive enough settlement money in cash to cover immediate bills and manage changes to a home or vehicle (i.e., ramps, bathroom safety bars, steering modifications) that will benefit their lives immediately. They can invest money set aside for emergencies with the help of a financial planner or place the funds in conservative no-load mutual funds. The balance of their settlement can then go into structured, tax-free annuities so they have enough monthly income for the rest of their lives even if investments hit a rocky period or fail altogether.

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Tax issues

Personal injury settlements are generally exempt from state and federal income tax. Settlement proceeds for personal physical injuries or physical sickness do not have to be claimed as income. The IRS also allows proceeds for emotional distress or mental anguish resulting from the personal physical injury or physical sickness to be excluded as income.

However, once the settlement proceeds are received, any income generated (i.e., interest, dividend payments) becomes taxable unless placed in tax-exempt government securities. A structured settlement not only gives plaintiffs a disciplined approach to managing their money, but significant tax benefits.

For example, a 30-year-old woman is injured in an automobile accident. She is faced with whether to put her $1 million settlement in a bank certificate of deposit or structure the settlement. The structured plan would pay her $2,464.90 per month guaranteed for 10 years for a total of approximately $1.3 million, tax-free. If she were to put the entire $1 million in a CD earning 3 percent and generating the same $2,464.90 per month, she would need to pay at least 28 percent in federal taxes and 10 percent in state taxes on the income.

Unlike a lump sum payout in which investment proceeds are immediately taxable, as long as the money remains in the underlying annuity (as shown in the example above) it compounds tax-free. Over time, the actual amount of the settlement grows.

In another example, an injured 35-year-old decides to receive $1,000 per month in year one of a 20-year guaranteed annuity. Since the lifetime annuity is compounding at 3 percent annually, his monthly payments increase to $1,305 after 10 years and $1,754 after 20. The monthly annuity payments will continue during his lifetime, reaching $4,256 per month after 50 years and continue to compound for as long as he is alive.

Safety

When funds are structured, they are primarily placed in an annuity purchased from an A+-rated life insurance company. The underlying investments are corporate grade bonds, or in some cases, U.S. Treasuries for greater diversity.

Annuities are guaranteed by the issuing life insurance company. In California, companies offering structured settlements must be first approved by the California Department of Insurance. The department evaluates the insurance carrier's solvency and whether the carrier complies with California regulations. Carriers are also subject to mandatory annual audits and other financial compliance requirements.

Proper planning

The key to the success of a structured settlement is proper planning early in the settlement process. This is the time when injured clients decide on the mechanics of the structure – how much should be received upfront, an estimate of the amount that will be needed to pay for college or other big expenses and how much is required for daily living expenses. It is also when to determine whether a Medicare Set-Aside account (MSA) is needed so that Medicare can pay future medical costs after funds in the MSA are exhausted.

For parents of younger injured children, a structured settlement is especially important. It enables parents to secure the child's financial future. Once they turn age 18 (the age of majority), they have access to settlement funds and can run through the money quickly. Setting up a structured settlement for injured young adults eliminates the temptation to squander the funds.

Structured settlements are inflexible

Structured settlements offer great flexibility at the time they are created, but are difficult (near impossible) to change once established. Because of the rigidity of the structure, the balanced approach to investing the settlement proceeds will help eliminate the need from ever having to sell the annuity portion of the settlement.

Factoring annuities

When a true financial emergency does occur, factoring companies can step in to purchase the annuity. In these cases, the lawyer who handled the settlement is notified before any buyout can take place. As the client's attorney, you are required to counsel the injured party so he or she is fully informed of the consequences of selling future annuity payments. A court reviews the injured party's current and future financial needs and whether the injured party has received legal counsel concerning the factoring company's buyout and fees. After passing these procedures, the factoring company can purchase the annuity payments, extract its fee and forward the remaining agreed amount in cash to the client.

Accounting for market uncertainty

Structured payments are predictable and guaranteed. Unlike non-structured investments, market fluctuations do not impact the agreed-upon annuity payments. Those regular, steady annuity payments will remain constant. Some insurance companies offer an inflation-adjusted structure plan to account for cost-of-living increases.

A guaranteed income stream can be a significant advantage when the injured party has no other source of income. Clients should avoid the temptation of investing in high return-high risk investments with their upfront cash. Chances are good that the inevitable market downturn, corporate bankruptcy or unforeseen global calamity can quickly wipe out cash flow.

Patrick Farber is a structured settlements broker with Atlas Settlement Group, serving California. He works with attorneys to create structured settlement annuities for physical and non-physical injury cases. He provides support and advice during all phases of the settlement process – at no cost to attorney or client. pat@patfarber.com.

Enrique Sierra is a case manager at Atlas and assisted with the article.

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