ANNUITIES AND MANAGED MONEY

Paul J. Lesti, CSSC
Lesti Structured Settlements, Inc.
745 Distel Dr.
Suite 114
Los Altos, CA 94022
(650) 903-4100
paul@lesti.com

There is a critical intersection between legal, financial, and economic issues when settling lawsuits. Many lawyers may feel uncomfortable with figures, and may not want to give advice regarding the financial, economic, and tax issues surrounding their client's legal settlements. Attorneys, however, have a duty to advise clients in areas outside the law,[1] and to recommend a consultation with a professional in another field, such as economic matters, when a competent lawyer would do so.[2] It is important for an attorney to examine and have the financial needs of

---

[1]ABA MODEL RULE OF PROF'L RESPONSIBILITY 2.1 (5th ed. 2003).

> RULE 2.1 ADVISOR In representing a client, a lawyer shall exercise independent professional judgment and render candid advice. In rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation.

[2]*Id*. at cmt. 4.

> Matters that go beyond strictly legal questions may also be in the domain of another profession. Family matters can involve problems within the professional competence of psychiatry, clinical psychology or social work; business matters can involve problems within the competence of the accounting profession or of financial specialists. Where consultation with a professional in another field is itself something a competent lawyer would recommend, the lawyer should make such a recommendation. At the same time, a lawyer's advice at its best often consists of recommending a course of action in the face of conflicting recommendations of experts.
>
> ANNOTATION. ADVISING ABOUT NONLEGAL CONSIDERATIONS
>
> Rule 2.1 specifically condones the lawyer's reference to nonlegal considerations—such as moral, economic, social, and political factors—when giving advice. As the Comment explains, advice given in purely legal terms may be inadequate, particularly when other considerations, such as cost or the effect on others, are important to the client. Thus, "[a]lthough a lawyer is not a moral advisor as such, moral and ethical

the plaintiff addressed. This is especially important when the client is unaware of such considerations such as annuities, structured settlements, or managed money, and their importance, or when the client needs more than just narrow legal advice.[3]

A common factor for every injured person is the requirement of the plaintiff's basic living needs of food, shelter, health care, and transportation. Attorneys should also consider the plaintiff's basic goal of replacing a lost paycheck and fringe benefits if the injured person cannot return to work. These needs can be met in a variety of ways. The plaintiff's financial needs may be met by using the best financial instruments available that have specific investment objectives. Annuities and managed money will be discussed in this context of meeting the financial needs of plaintiffs.

Here are some definitions and explanations.

Managed money—This term is self-defining as the plaintiff, an advisor, a money manager, or a combination of people may direct and manage the settlement fund. There is no promise of performance or guarantee of future payments, and the funds are at risk for capital loss. There is the potential for increased capital growth in the investment. Such investments may include fixed income investments, stocks, bonds, and mutual funds.

Annuity—

> considerations impinge upon most legal questions and may decisively influence how the law will be applied." MODEL RULE OF PROF'L CONDUCT 2.1 cmt. 2 (2002). *See* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 94(3) (2000) ("In counseling a client, a lawyer may address nonlegal aspects of a proposed course of conduct, including moral, reputational, economic, social, political, and business aspects.").

[3] RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 94(3) cmt. h.

> h. Advice concerning nonlegal considerations.
> As stated in Subsection (3), a lawyer's advice to a client may properly include the lawyer's views concerning aspects of a proposed course of conduct that are not narrowly legal in nature. Such advice, when given as part of legal services provided to the client, is within the scope of § 72 for purposes of the attorney-client privilege, and it is within § 59 for purposes of the general duty of confidentiality (see § 60). A lawyer's advice on significant nonlegal aspects of a matter may be particularly appropriate when the client reasonably appears to be unaware of such considerations or their importance or when it should be apparent that the client expects more than narrow legal counsel. A lawyer is required to provide such assistance when necessary in the exercise of care to the extent stated in § 52. Whether a lawyer may appropriately charge an hourly fee for advice defined in this Comment depends on whether the parties contemplated that the lawyer's compensated services would include such advice (see § 38).

> An annuity is a contract in which an insurance company makes a series of income payments at regular intervals in return for a premium or premiums that you have paid. Annuities are most often bought for future retirement income. Only an annuity can pay an income that can be guaranteed to last as long as you live.[4]

Immediate annuity or a **deferred** annuity—

> With an *immediate* annuity, income payments start no later than one year after you pay the premium. You usually pay for an immediate annuity with one payment. The income payments from a *deferred* annuity often start many years later. Deferred annuities have an accumulation period, which is the time between when you start paying premiums and when income payments start.[5]

Fixed deferred annuity—During the accumulation period for a *fixed deferred* annuity, your money (less any applicable charges) earns interest at rates spelled out in the annuity contract. The company guarantees that it will pay no less than a minimum rate of interest. During the payout period, the amount of each income payment to you is generally set when the payments start and will not change.[6]

Equity Indexed Annuity—An equity-indexed annuity is a fixed annuity, either immediate or deferred, that earns or provides benefits that are linked to an external reference or an equity index. The S&P 500 Index is one commonly used index. When you buy an equity-indexed annuity you own an insurance contract. You are not buying shares of any stock or index.

Credit to the annuity value is based on a formula related to changes in the linked index.

> Your equity-indexed annuity, like other fixed annuities, also promises to pay a minimum interest rate. The rate that will be applied will not be less than this minimum guaranteed rate even if the index-linked interest rate is lower. The value of your annuity also will not drop below a guaranteed minimum.[7]

It is possible to have growth potential without market risk, as the principal is guaranteed. Income taxes are due only when one withdraws funds. If the annuitant becomes hospitalized or confined to an eligible nursing home for a period of time, for example 30 to 90 consecutive days

---

[4]National Association of Insurance Commissioners, *Buyer's Guide to Fixed Deferred Annuities* (July 12, 2004).

[5]*Id.*

[6]*Id.*

[7]*Id.*

after the contract's effective date, there are no surrender charges.[8] This may not be available in all states.

The accumulation value is paid to the beneficiary without a surrender charge upon the death of the annuitant. This may potentially avoid the expense and delay of probate. Withdrawal policies vary with different contracts. Some firms allow a 90 percent withdrawal of the investment after one year. Others firms, after seven years, allow withdrawals up to 100 percent of the annuity's value with no charges.

Many investors after the "dot com" stock market crash in the spring of the year 2000, no longer want their investments subject to the extreme downside volatility of the equities market, but they still want participation in any stock market increases. In addition, such investors may require a minimum guaranteed increase in their investment. A fixed equity-indexed annuity with a guaranteed rate of return and a guarantee of principal may be a solution for such investors.

Variable annuity—During the accumulation period of a *variable* annuity, the insurance company puts your premiums (less any applicable charges) into a separate account. You decide how the company will invest those premiums, depending on how much risk you want to take. You may put your premium into stock, bond or other accounts, with no guarantees, or into a fixed account, with a minimum guaranteed interest. During the payout period of a variable annuity, the amount of each income payment to you may be fixed (set at the beginning) or variable (changing with the value of the investments in the separate account).[9]

Structured Settlement—A structured settlement is an arrangement by suit or agreement where damages paid as periodic payments for personal physical injury or physical sickness damages are excludable from the recipient's income under Internal Revenue Code (I.R.C.) § 104(a)(2). It can also be an agreement for the periodic payment of compensation under a workers' compensation law where the payments are excludable from the recipient's income under I.R.C. § 104(a)(1). In addition, the periodic payments must be fixed and determinable as to amount and time of payment, and cannot be accelerated, deferred, increased, or decreased by the recipient of such payments, per I.R.C. § 130(c)(2)(A) and (B).[10] If the defendant wants to assign its obligation to

---

[8] *See* I.R.C. § 72(q)(2)(A) & (B), which excludes a 10 percent early withdrawal penalty in the event of death or disability.

[9] *Id.*

[10] I.R.C. § 5891(c)(1).

> Structured Settlement—The term "structured settlement" means an arrangement—
>
> (A) which is established by—
> (i) suit or agreement for the periodic payment of damages excludable from the gross income of the recipient under section 104(a)(2), or
> (ii) the agreement for the periodic payments of compensation under any workers' compensation law excludable from the gross income of the recipient under section 104(a)(1), and

a third party using I.R.C. § 130, then only a "qualified funding asset" may be used. A qualified funding asset is an annuity contract, or any obligation of the United States.[11]

A structured settlement is the only investment vehicle that will provide tax-free, management-free, guaranteed payments that cannot be outlived. The obligation to make the payments is normally guaranteed by a large, regulated life insurance company or an insurance holding company. There are no ongoing management fees or expenses. An inflation increase may be built into the payments so that the person is able to purchase the same amount of goods and services now and in the future. If it is in the "best interest"[12] of the payee, the payments may be changed subject to the approval of a court. There are also commutation riders available that will allow the payments to be accelerated if the annuitant dies, which provides estate tax protection. Some life insurance companies are willing to internally factor any future payments when requested by the annuitant. Such a transaction may be subject to court order under appropriate laws.[13]

Torts and the financial needs of the plaintiff—It is useful to consider the intersection of the tort recovery system and the financial needs of the plaintiff. When settling a lawsuit the attorneys, adjusters, mediators, and judges are normally focused on legal and valuation issues. When a settlement is at hand, the focus shifts to not just the amount of funds but how they will be structured to meet the needs of the plaintiff.

For example, if the plaintiff obtains all of the damages requested, there isn't always enough money recovered to cover the economic damages. Take for example a 50-year-old laborer who is injured in an accident and is unable to continue working. The $1,500,000 demand consists of $800,000 in lost wages, $200,000 in lost fringe benefits, and $500,000 in pain and suffering. All figures are in present value. After a standard one-third legal fee and $100,000 in expenses, the net recovery to the plaintiff is $900,000. This is $100,000 below the present value of the future economic damages. Since the person cannot return to work, he is retired from a financial point of view. Persons who are retired typically do not want to be exposed to capital market risks. A guaranteed investment may be the best choice for such a person. An allocation to a structured settlement, an immediate annuity or an equity indexed annuity with no capital risk may be appropriate options to consider. In the above example, even if all damages are received, after

---

> (B) under which the periodic payments are—
> (i) of the character described in subparagraphs (A) and (B) of section 130(c)(2), and
> (ii) payable by a person who is a party to the suit or agreement or to the workers compensation claim or by a person who has assumed the liability for such periodic payments under a qualified assignment in accordance with section 130.

[11]I.R.C. § 130(d).

[12]I.R.C. § 5891(b)(2)(A)(ii).

[13]I.R.C. § 5891(b)(2)(A)(i) requires that a transfer "does not contravene any Federal or State statute or the order of any court or responsible administrative authority."

fees and expenses the net amount to the plaintiff may not cover all economic damages. Basic lifetime living expenses should be considered a priority in such instances.

On the other hand, a different person, who is able to return to work, and who obtains a $1,500,000 settlement may have a different risk aversion and may want full exposure to the equity markets, and may not require any downside market protection. For such investors a managed growth account will provide such an investment opportunity.

Plaintiff's needs—The financial requirements of the plaintiff should be reviewed and the plaintiff's basic living expenses should be a major priority. The average annual income of all

consumer units in 2003 was $51,128 and the expenditures were $40,817.[14] This amounts to 80 percent being spent for basic living needs. The expenditures are as follows:

Average annual expenditures of all consumer units, Consumer Expenditure Survey	
Item	**2003**
	All units
Income before taxes	$51,128
Average annual expenditure	$40,817
Food	$5,340
Housing	$13,432
Apparel and services	$1,640
Transportation	$7,781
Health care	$2,416
Entertainment	$2,060
Personal insurance and pensions	$4,055
Other expenditures	$4,094

Based on the averages, most families need over $40,000 in 2003 dollars to survive. If the plaintiff cannot return to work, then a guaranteed lifetime replacement of $40,000 may be required just to cover the basic living expenses of the family. Many fringe benefits are received by employees tax free, and may not be counted in this survey. Therefore, these benefits must also be replaced and it may take more that $40,000 to replace them. Many plaintiffs involved in personal injury lawsuits do not have the financial knowledge, experience, skill, or track record at investing funds. Therefore protecting plaintiff's financial recoveries to take care of the plaintiff's basic living needs is essential. This lack of financial investment experience or skill cuts across class, race, and socioeconomic boundaries. Payments for basic living needs may be required for life, as contributions to retirement plans and Social Security may have been discontinued due to the person's injury.

It may be possible to build triple emergency fund protection into an asset allocation for a plaintiff. First, one may create a liquid account that is truly to be used for emergencies only. One can consider three to six months of living expenses invested in a money management account. The second fund may be a growth or investment account that allows money to be taken out with no tax penalty in the event of death, disability, hospitalization, or the payee entering a nursing home. An equity indexed annuity with no potential risk of capital, or a managed account with a growth objective may both be considered for this. The third account will be the income producing account that is allowed to be accessed in the event the first two are exhausted and/or if

[14] U.S. DEP'T OF LABOR, U.S. BUREAU OF LABOR STATISTICS, CONSUMER EXPENDITURES IN 2003 (Nov. 30, 2004), *at* http://www.bls.gov/cex/csxann03.pdf. Other consumer units will have different consumption experiences.

the withdrawal meets the appropriate legal requirements.[15] A trust overlay on these investments may add spendthrift and factoring protection if this is required.

In addition, to the above triple emergency fund strategy, some may feel that giving the plaintiff a new financial start by paying off consumer debts such as credit cards and car loans may be a good financial goal.

Dissipation—The hot car, the hot girl, and the telephone pole. There is the story of a young man who had a substantial amount of money from a settlement sitting in a blocked bank account. On his 18th birthday he withdrew the money, bought a high performance car, drove by his girlfriend's house to take her for a ride, and proceeded to wrap the car around a telephone pole. Now what if he did not have insurance? What if the girlfriend was profoundly injured and the young man still had a substantial amount of cash? What if the funds were earmarked for tuition, and now, in just a matter of a few hours, he can no longer afford to attend college? A minimum level of settlement planning would have prevented such a tragedy. Many attorneys and parents allow an appropriate amount to be paid at age 18. Then, semiannual tuition payments and a monthly stipend during college may help avoid such a dissipation of funds. Graduate or professional school, or other training should also be considered.

At least one spouse of a September 11 victim has publicly discussed her spending habits. Ms. Kathy Trant said that she has approximately $500,000 remaining from her $5 million settlement.[16] Structured settlements, annuities, and trusts are tools that attorneys can use to help prevent such dissipation examples.

Mortality—As people live longer in our society many are considering how they will provide for themselves in retirement. Similarly for injured individuals, the age and rated age of the plaintiff is an important item to consider. If a plaintiff has a medical condition or injury—it does not matter if it is related or unrelated to the lawsuit—that person may be rated as if he or she was older than his or her chronological age. For example, a profoundly injured girl who is currently 2 years old, may be rated as if she has the life expectancy of a healthy normal 60 year old. The rated age is 60, but the chronological age is 2. This age rating is only for purposes of providing the cost of the future annuity payments. The cost of providing $3,500 per month for life with the first 10 years certain, and payments increasing at 3 percent is $1,700,000 for a 2-year-old girl with no injury and $813,000 for a profoundly injured girl with a rated age of 60.

In most life care plans for profoundly injured plaintiffs that this author has reviewed over the past 25 years, the cost of attendant or institutional care is normally 70 percent to 80 percent of the entire plan's cost. This means that as long as the plaintiff is alive, a significant, steady stream of guaranteed payments will be required.

Risk—There is a continuum of risk when it comes to investment vehicles. One school of thought is that the investment with the lowest risk is the Bank of "Serta" i.e., money put under a mattress. At the other end of the risk continuum one may find unregulated hedge funds. The

---

[15] *See, e.g.*, I.R.C. § 5891.

[16] *Grieving Widow Spends Almost $5 Million* (ABC News television broadcast, June 13, 2005).

bank of “Serta” has its own unique risks such as fire, hurricanes, and theft. Starting with what is currently considered the safest investment: U.S. Treasury bills, notes, and bonds; one then can continue up the risk ladder to CDs, annuities, money market funds, bonds, mutual bond funds, stock mutual funds, individual stocks, and then to options and hedge funds at the riskier end of the spectrum.

How does one gauge a client’s risk aversion and even your own? What it may come down to is how comfortable one may feel in front of a judge 5 to 10 years from now explaining the due diligence methodology that was followed for the plaintiff’s settlement plan. There is an old adage on Wall Street that says, “You can sleep well or you can eat well, but you can’t do both.” It may be appropriate for some non-risk adverse investors who can replace income to have exposure to the volatile capital markets and potentially lose some of their investment. Normally, capital risk exposure may not appropriate for those who: (1) cannot return to work, (2) do not have another source of income, or (3) require steady long-term or lifetime income to pay for basic living expenses.

Taxes—Since medical expenses are deductible, if a plaintiff has large amounts of future medical expenses, this may help towards leveling the tax playing field when a taxable investment portfolio is considered versus a tax-free structured settlement. However, the security and peace of mind of having a large regulated life insurance company providing lifetime, guaranteed, and management-free benefits from a structured settlement or a taxable annuity may be the better vehicle for replacing long-term payments even if there are potential future medical deductions.

The tax rate of a trust should be accounted for when considering a managed account. Since trusts are taxed at 39.6 percent of the amount over $7,500 in income,[17] one must calculate the taxes owed on the amounts remaining in the trust, and also those taxable distributions to the payee. If a trust is required, a tax-efficient solution is to have tax-free payments from a structured settlement paid into a trust. An appropriate upfront amount to seed the trust account should be considered as discussed above in the **Plaintiff’s needs** section.

Guaranteed payments—Since annuities are the only investment that can provide guaranteed lifetime payments, an attorney should be extremely careful if a client rejects a guaranteed lifetime stream of payment.[18] A managed portfolio can promise the potential of future growth, with a possible loss of capital, but it cannot promise guaranteed lifetime payments. Therefore there is always the risk that the payments from a managed portfolio may not last for the plaintiff’s lifetime. How does one measure this risk of running out of money in a managed

---

[17] 26 U.S.C. § 1(e)(2).

[18] A letter documenting the plaintiff rejecting a structured settlement may be prudent to have in the file. *See also* Grillo v. Mike Henry, Cause No. 96-167943, 96th District Ct. of Tarrant County, Texas; and Grillo v. Pettiette, T.E. Swate and Hardy, Milutin & Johns in the 96th District Court of Tarrant County, Texas, Cause No. 96-145090-92, (concluded March 23, 2001). Where a guardian ad litem and a law firm settled for $2.5 million and $1.6 million, respectively, due to, among other things, a special needs trust being improperly funded to care for the lifetime of an injured child, failure to preserve access to public benefits, and a structured settlement also not being considered.

portfolio before the plaintiff dies? One way to measure such risk is to use a probability analysis such as a "Monte Carlo Simulation" or MCS. Since gaming is associated with the city of Monte Carlo this analysis was named for it. The MCS is a way of measuring risk, and it will be explored in the context of investments.

Let's explore risk and projected rates of return. If a projected average rate of return assumption is 7 percent, and if every year it is assumed that the average is met, one has assumed that there is zero risk that the 7 percent rate of return *will not* be achieved. This traditional straight line investment return assumption does not accurately reflect the risk of achieving future rates of return. One must account for the uncertainties of future investment returns. The 7 percent is merely the average of past rates of return. In one year the rate of return may be 9 percent and in another it may be 2 percent, in another year it may be 10 percent and in another, it may be negative 20 percent.

It will be more accurate to look at the randomness of the likely rates of return, and use each one separately to calculate the probability of an investment achieving its goal over the long run. For example, one may write down on slips of paper, the rates of return over the past 71 years from a stock index and place them in a bowl. A slip of paper is chosen for the rate of return for one year, and then it is returned to the bowl, so that one event does not affect the other. This is to ensure complete randomness as in gambling, as one roll of the dice does not affect the next. After picking 71 slips of paper one obtains one trial. One may perform this trial 1,000 times (using software) to calculate the risk that a projected income stream will last for that person's lifetime. For example, Dave Jordan, a 40-year-old male, has $1,000,000 after fees and expenses to invest. A structured settlement generates $62,818 annually, with the first 10 years certain, increasing 3 percent that will be paid as long as he is alive (assumed to be to age 84 for this example). Using a Monte Carlo analysis and the S&P 500 index fund for the past 71 years, (since 1933 near the absolute bottom of the U.S. stock market), 675 is the number of times out of 1,000 iterations there is money left over. That means there is a 67.5 percent chance there will be enough funds for his lifetime.[19] Each case and portfolio may be different, but a structured settlement will meet this payment stream's financial goal 100 percent of the time.

One key point of assuming an expected range of rates of return instead of just one average rate of return is measuring what happens when there is a loss. Assume that one begins with a portfolio of $1,000,000. After upfront expenses, management fees, and administrative fees, assume one is left with $960,000. If the portfolio loses 20 percent in the first year, one is left with $768,000. Even if the portfolio increases 20 percent next year, instead of getting back to the initial $960,000 amount and breaking even, one only has $921,600 at the end of year two (1.2 times $798,000). This is because the rate of return is based on the amount in the portfolio at the beginning of the year.

---

[19]Assumes $1 million to invest less 4 percent expenses to generate $62,818/yr. in lifetime payments growing 3 percent, with the first 10 years certain, for a 40-year-old male, (with a rated age of 60) payments starting in one year. $2,400 in annual expenses added. Even if the Monte Carlo analysis's time period is shortened to 24 years to account for the rated age of 60, the success rate is 80.6 percent. However, this assumes that the life expectancy forecast used by the investor is 100 percent accurate. In general, see the *Grillo* matter in footnote 18, *supra*.

Lifetime needs, flexibility, and money for heirs—This topic is a double-edged sword in the context of legal settlements. On the one hand plaintiffs may want to have lifetime income, growth in the investment portfolio, no capital risk, a guaranteed rate of return, and also have their heirs inherit all the money that was invested when they die. With so many competing financial goals, one should allocate funds towards the appropriate investment that gives the desired result. For example, if one wants to leave money to heirs upon death, then a term life insurance product,[20] or an annuity or a structured settlement with a commutation payment due upon death may be good choices to consider. If one wants lifetime income, then an annuity is a good choice. If one wants growth, then exposure to the equity markets may meet that need. Each investment type has a specific objective and meshing the plaintiff's financial needs with those investment objectives should be given careful consideration. Here is a chart that summarizes some of the salient needs that plaintiffs may experience and some potential investment options to meet those needs.

FINANCIAL NEEDS	**POTENTIAL APPROPRIATE INVESTMENTS OPTIONS**
Lifetime tax-free income	Structured settlement annuity
Lifetime taxable income	Fixed immediate or deferred annuity
Growth, no capital risk with a minimum guaranteed rate of return.	Indexed annuity with capital protection, Variable annuity with capital protection
Growth with capital at risk	Managed account
Emergency cash fund	Short term liquid investments CDs, money market accounts, bond fund.

The above chart illustrates that it may be best to separate, for example, goals of capital growth with no capital risk from a goal of tax-free lifetime income. One may be better served investing in different financial vehicles to achieve these separate goals. One will allocate funds towards a structured settlement if lifetime tax-free income is desired, and one will put money in an equity indexed annuity if capital growth with no capital risk is desired. In addition to the investment's financial goals, if spendthrift, public benefit eligibility, factoring protection, and control over the expenditures of the payee are desired, then simply having a trust overlay on any of the above investments may help achieve these other goals.

Medical Insurance—Existing or future medical insurance coverage that may become available to the family, as well as publicly available benefits should also be considered. If a parent has insurance that covers an injured child, then that may make the family feel more secure about the child's future medical care. However, a parent may feel trapped in his or her career if moving from this job may jeopardize future coverage for the child.

Flexibility—The perceived flexibility of payments should be considered when looking at different investment options for a plaintiff.

[20]Many plaintiffs may have to pay higher premium rates than a healthy person, or they may be uninsurable. One may want to consider what risk is being addressed or what income stream is required to be replaced when purchasing life insurance.

The payments from a structured settlement can be accelerated if it meets the "best interest of the payee."[21] Commutation riders are available that provide for payments to be accelerated if a payee dies, to provide estate tax protection. Some life insurance companies are willing to internally factor any future payments when requested by the annuitant. Such a transaction may be subject to court order under appropriate laws.[22] If a factoring transaction does not follow the terms of I.R.C. § 5891 then a 40 percent tax is imposed.[23] Equity indexed annuities also provide for an acceleration of funds if the annuitant has entered a nursing home or a hospital or has died.[24]

A managed money portfolio has flexibility in withdrawals of funds and this normally requires ongoing trust, administrative, management, investment, accounting, and tax return costs and fees. If one demands 100 percent complete flexibility of future payments, one may assume that it is too difficult to anticipate the future needs of such a person. Most attorneys hire experts in medicine, life care planning, and economics to calculate anticipated future expenses and present such information at trial. Consulting with such experts is key to producing a prudent settlement plan that meets the plaintiff's financial needs. Such extreme flexibility may not be required by those who have planned for their client's financial needs. The majority of basic living needs such as housing, food, clothing, and transportation can be handled through a fixed income investment allocation such as an annuity or a structured settlement. Anticipated or reasonably expected medical needs can be appropriately scheduled.

One may minimize the risk of not meeting unanticipated medical needs by using the triple emergency fund technique described in the **plaintiff's needs** section above. In addition to the living expenses mentioned, one may consider prepaying the first two years of medical expenses, the first anticipated operation, and the first major appliance replacement, i.e., a wheelchair or a specially equipped van into the first emergency fund.[25] The amount to invest in the second emergency medical fund account will depend on the nature of the person's injury, and the amount of future expenses that have already been scheduled into an income producing investment, which is the third emergency fund.

The ability to pull money out of an investment competes with an income investment goal that is supposed to provide long-term or lifetime payments. Invading the principal of an income

---

[21]I.R.C. § 5891(b)(2)(A)(ii) requires that the qualified order find that the transfer, "is in the best interest of the payee, taking into account the welfare and support of the payee's dependents."

[22]I.R.C. § 5891(b)(2)(A)(i), *supra* note 13.

[23]I.R.C. § 5891(a) and (c)(4).

[24]I.R.C. § 72(q)(2)(A) & (B), *supra* note 8.

[25]*See Medicare Secondary Payer (MSP)—Workers' Compensation (WC) Additional Frequently Asked Questions*, CMS All Regional Administrators, Memorandum (Oct. 15, 2004), *at* http://new.cms.hhs.gov/WorkersCompAgencyServices/Downloads/101504Memo.rtf. Answer 5. The suggested amounts to be prepaid are greater than the requirements of the CMS for amounts to be pre-funded when using a structured settlement.

producing investment reduces its future periodic payments. It may be best to separate the two goals of income and growth into two separate investments. As the chart above mentions, if income is needed then a tax-free structured settlement annuity or a taxable annuity will meet those needs. If growth with no capital risk and a guaranteed rate of return is required, then an equity indexed annuity may be appropriate. If growth at a potentially higher rate of return that requires a capital risk is desired, then one may be better served with a managed money fund.

Fees—The attorney and plaintiff should be aware of the costs and commissions involved in the various investment options to be paid at the time of the investment and in the future. Some fees may include commissions, administrative fees, investment advisory fees, trust fees, mutual fund fees, and transaction fees and costs to trade securities, and so on. It is also important to know whether the commissions are taken out of the investment itself or already included. For example, if a 4 percent commission on a $1,000,000 investment is taken out of the amount placed into the account, then only $960,000 remains to be invested. Annuities normally are illustrated to include the commissions in the proposed rates of return.

Freedom to choose investment options—Plaintiff attorneys may use a 468B fund to allow the greatest financial flexibility for their client's settlement money. Even a structured settlement may be used from this fund. If a request[26] is granted to amend an IRS revenue procedure, positive tax direction will be given allowing settlement monies from a lawsuit involving only one plaintiff, to be placed into a 468B settlement fund. This regulation allows a 468B fund to act as a party to a lawsuit, allowing it to assign an obligation to make periodic payments under structured settlement to a third party. A single claimant 468B fund is currently accepted by some life insurance companies. This is not an issue for lawsuits with more that one claimant. A positive response to this request to amend the revenue procedure will allow plaintiffs to choose any investment option and not the one the property and casualty company prefers. This may affect the influence that some defendants attempt to exert on a plaintiff's investment choice.[27]

Ownership safety—It is important to consider the risks of ownership or control of the underlying assets used in various investments. In a structured settlement annuity the owner is normally an assignment company that is guaranteed by a large life insurance company. In an instance where a life insurance company invested a significant amount of its assets in junk bonds, a liquidity shortfall led to an insurance commissioner takeover. All of the annuities issued by Executive Life of New York were paid 100 percent and the vast majority of Executive Life Insurance Company of California annuitants, estimated at 98 percent, were repaid 100 percent of their benefits.[28]

---

[26]A request to clarify I.R.S. Rev. Proc. 93-34, to allow lawsuits with a single claimant to use 468B funds is currently pending. Letter from Goldberg, Gideon and Brewster (of Skadden, Arps, Slate, Meagher & Flom LLP) to Pamela F. Olson, Assistant Secretary, Department of Treasury and B. John Williams, Chief Counsel, Internal Revenue Service, of June 19, 2003. 2003 WL 22662008.

[27]Among other allegations, a property and casualty company had a policy of steering business to a related life insurance company. Macomber v. Travelers Property & Cas. Corp., 261 Conn. 620, 804 A.2d 180 (Conn. 2002); Macomber v. Travelers Property & Cas. Corp., No. X03CV990496761S, 2004 WL 1559183 (Conn. Super. May 26, 2004), 37 Conn. L. Rptr. 349 (unpublished op., check court rules before citing).

[28]*In* re Executive Life Ins. Co., 38 Cal. Rptr. 2d 453, 32 Cal. App. 4th 344 (1995).

In two instances, the underlying assets used to fund periodic payments were invaded and led to payee lawsuits to recover the shortfall. In the IBAR instance an assignment company together with a trust portfolio of $200 million in U.S. Treasury Bonds used to fund future periodic payments to over 300 payees was sold to a brokerage firm and then to two successive individual financiers. Complicating this situation, the original Trustee, Bank of America, sold its trust company to Wells Fargo Bank. The financiers then transferred the trusteeship to major financial institutions that the financiers believed to be more amenable to their concept of the ownership and control of the bonds. The final owner, Stanwich Financial used the bonds as collateral for loans. When the loans were in default the holder of the notes foreclosed on the Treasury bonds and they were sold to cover the loans. This led to an interruption of payments to the plaintiffs, several lawsuits being filed, including a class action, and an eventual settlement.[29]

In the SBU case, a judge ruled that SBU, Inc. could terminate Magna Bank as the trustee of structured settlement trusts. [30] In a subsequent stipulation, the trusts were transferred to Flag Finance Corp.[31] Eventually, Mr. James Gibson, used the funds for various expenditures and as collateral for a loan to invest in a grocery store chain. When the loan defaulted, the noteholder sold the bonds that were used for collateral. These were the same bonds that were supposed to pay the injury victims. Mr. Gibson fled to Belize, and he returned to a criminal prosecution and an estimated $57 to $67 million shortfall.[32]

The lesson learned from an insurance company being taken into rehabilitation is to investigate a life insurance company's financial ratios. The lesson learned from the trust company failures is to be sure the ownership, control, and the financial security of the underlying assets are properly protected, especially if there is a future sale.

Some of the salient issues regarding some potential investments are summarized in the following chart. There are at least five major components relating to managed money and annuities.

1. Those who market the financial vehicles
2. Those who provide the financial products
3. Those who are obligated to make the future payments
4. Those who administer the financial vehicles
5. The product itself

---

[29]*In* re Structured Settlement Litigation, Superior Court of the State of California, for the County of Los Angeles, Case No. BC244111. Some of the injured plaintiffs considered filing a legal malpractice action against the original personal injury attorneys but did not file an action due to resolution of the class action.

[30]238 Ill. Dec. 447, 288 Ill. App. 3d 1126, 711 N.E.2d 834 (1997).

[31] SBU, Inc. v. Magna Bank, National Association f/k/a Magna Trust Company, Stipulation and Proposed Order, November 25, 1997, In the Circuit Court of the Twentieth Judicial Circuit St. Clair County, Illinois, Case No. 93-MR-165.

[32]*The End of the Story*, National Structured Settlement Trade Association, Jan. 9, 2002.

The questions are presented in a chart format for ease of use. Some answers will depend on specific circumstances and are purposely left blank. One goal of this paper is to point out questions an attorney may ask when investigating financial vehicles for a particular client. The answer the attorney receives may depend on whom the attorney asks.

Issue/Feature/Concern	Structured Settlement	Growth Investment	Equity Indexed Annuity	Single Premium Annuity
A. Marketing Firm, Financial Product Provider, Owner/Obligor, and Administrator				
What type of entity is it?				
What states is it located and licensed in?				
Is there regulation by a third party overseer	Y		Y	Y
Is the investment independent of a key person's inability to perform their duties?	Y		N	N
What is the experience of the firm?				
Does the firm have E&O coverage?				
What occurs if there is a failure?				
What entity has jurisdiction over a rehabilitation or bankruptcy?				
1. Marketer				
Do Insurance, SEC or NASD regulations apply?	Y		Y	Y
Are payments subject to succession plan after the death of a principal?	N		N	N
Is a finder's fee offered to plaintiff's counsel?				
Is there a discount or waiver on other services already performed for plaintiff's counsel offered?				
Does a fee waiver or discount comply with state bar rules?				
2. Financial Product Issuer				
Are there third party rating agencies?	Y		Y	Y
What are the ratings?				
How do ratings compare to industry standards?				
What are the financial ratios and how do they compare to industry standards?				
Are there any guarantee funds?	Y		Y	Y
3. Owner/Obligor:				
What are the advantages / disadvantages to the entity type?				

Issue/Feature/Concern	Structured Settlement	Growth Investment	Equity Indexed Annuity	Single Premium Annuity
Is there a guarantor?	Y		Y	Y
Is there a government guarantee fund?	Y		Y	Y
May the guarantor be larger than the original defendant or its insurer?	Y		Y	Y
Who has all rights of ownership and control of the assets?				
4. Administrator				
Can the settlement documents be changed?				
Is there third party oversight, such as an auditor, independent investment advisor?				
May the administrator invest in funds they have an interest in?				
Is the administrator also the investment advisor for the fund it may invest in?				
Are there rules on self-dealing that must be complied with?				
Are the fees different if the administrator is also the investment advisor?				
What are the commissions, administrative, advisory, trust, mutual fund and broker dealer expenses?				
Are commissions paid from the amount placed into the account or is the entire investment amount invested?				
Who can affect or change the investment?				
What is the formula used for investment decisions?				
Is the formula required to be disclosed to the SEC or the NASD?				
Are securities with a capital risk appropriate for wage earners who cannot return to work, incompetents, minors and profoundly injured plaintiffs?				
Is the administrator held harmless in the documents?	NA		NA	NA
How are investment disagreements resolved?	NA		NA	NA
5. Product				

Issue/Feature/Concern	Structured Settlement	Growth Investment	Equity Indexed Annuity	Single Premium Annuity
Are payments free of federal and state income taxes?	Y	Depends	N	N
May payments be guaranteed for as long as the person is alive?	Y	N	Y	Y
Is there a guaranteed rate of return?	Y	N	Y	Y
Are future payments guaranteed?	Y	N	Y	Y
Does a person's impaired health increase future payments?	Y	N		Y
Is the investment protected against potential capital losses?	Y	N	Y	Y
Is there a state or federal guarantee fund available?	Y		Y	Y
Is an inflation adjustment available?	Y	Depends	Y	Y
Is the investment protected against fluctuations in interest rates?	Y	Depends	Y	Y
May funds be available for estate taxes?	Y	Y	Y	Y
May payments be customized to meet the plaintiff's needs?	Y	Y		
Does the invasion of principal affect future payments?	Y	Y	Y	Y
Do the payments continue when the payee dies?	Y	Y	Y	
May the funds be accelerated?	Y	Y		
What is the process of accelerating or withdrawing funds?	I.R.C. § 5891			
Can funds be withdrawn if the payee dies or enters a hospital or nursing home avoiding a 10% tax penalty?	Y			
Can payments continue for the lifetime of the spouse if the annuitant dies?	Y		Y	

Conclusion—Annuities and managed money portfolios have different financial objectives. Annuities such as structured settlements can provide guaranteed lifetime, tax-free, management-free income. An equity indexed annuity can provide plaintiffs with growth and protect against any investment loss. Managed money can also provide potential growth along with a capital risk. Whatever the financial goals of a plaintiff, attorneys should carefully select advisors and the proper financial tools that will address and meet the needs of the injured plaintiff.

Reprinted with permission from ATLA's 2006 Winter Convention Reference Materials. *Copyright © 2006 Association of Trial Lawyers of America. Further reproduction of any kind is prohibited. For more information, please contact ATLA Education at education@atlahq.org or by phone at (202) 965-3500, ext. 612, or (800) 622-1791.*