



# For The Defense™

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A black and white illustration of a man in a suit pouring coins from a bowl into a large hand. The man is standing on a large, dark, textured surface that resembles a giant hand. He is holding a bowl filled with coins and pouring them into the palm of the hand. The background is a textured, light-colored surface.

Avoid the Problems of All-Cash Negotiations

# Effective Negotiation through Structured Settlements

by **James J. Yukevich**  
and **Alexander Calfo**

**More than 20 years have passed** since federal law and IRS regulations formally encouraged claimants to resolve physical injury and wrongful death litigation with structured settlement annuities. Since the late 1990s, use of structured settlements has grown considerably as economic uncertainty and Wall Street scandals undercut even the savviest financial plans. For many plaintiffs, the prospect of guaranteed tax-exempt payments looks increasingly appealing amid oil spikes and terror alerts.

For defense counsel, therefore, it is increasingly important to act on the potential appeal that structured annuity payments have for injured plaintiffs. This is particularly true for minors, spouses in wrongful death actions, and any plaintiff likely to have extended expenses relating to his or her tort claim. Also, in some circumstances (*e.g.*, minors, the mentally disabled or workers' compensation claims), structured payments may be required either by law or by the presiding court as a condition of approval.

Granted, structured settlements will not always be appropriate. If damages are expected to be less than \$10,000 or if the plaintiff is near the end of life expectancy and has no dependants, the notion of deferred periodic payments may not have much value. But that still leaves considerable opportunity to involve deferred periodic payment options in pre- and post-trial negotiations.

This article will introduce the legal foundation of federal structured settlement law and describe common types of structured settlements and the situations for which they can be used. Throughout the article, we will also provide tips for involving and benefiting from having structured settlement consultants in the negotiation process.

## Federal Law and Structured Settlements

There is no agreed-upon instance of the



James Yukevich has more than 20 years experience defending major domestic and foreign corporations in high exposure cases, including automotive, tire, heavy machinery, and drug and medical device manufacturers. Alexander Calfo specializes in complex general liability litigation and product liability cases. They are name partners in Yukevich Calfo & Cavanaugh in Los Angeles and have been involved in trials in jurisdictions throughout the United States. Both are members of DRI.

As a service to its members, DRI has recently established a new section on its website devoted solely to structured settlements. Designed for members who may be unfamiliar with aspects of the process, this page contains links to numerous applicable documents, including texts of federal structured settlement law and IRS private letter rulings, model settlement documents, and information for the claimant about the financial benefits of choosing tax-exempt payments. To view this members-only section, visit [www.dri.org](http://www.dri.org), log in and click on "Content Directory," and then access the "Third-Party content" subfolder.

first periodic payment settlement, but most agree that the concept of deferred settlement payments emerged around 1970 as large jury verdicts became more commonplace. In 1962, Thalidomide was pulled from the U.S. market after being linked to thousands of birth defects. The resulting litigation produced not only large settlements, but also involved minors with long-term financial needs. Attorneys began settling cases with periodic payments, but the practice was not widespread because of limited federal guidance on the tax implications.

Since 1919, U.S. law has recognized that damages for physical injury should be excluded from income taxation (*see* Revenue Act of 1918, Pub. L. 65-254, 213(b)(6), 20 stat. 1057, 1066 (1919)). That law later became codified in Internal Revenue Code 104(a)(2), which holds that damages received in a lump sum "on account of" physical injury are excluded from a plaintiff's gross income. Under section 104(a)(2) as interpreted by the courts and the IRS, however, interest and investment earnings on a lump sum settlement are not excluded.

The uncertainty over what portion of the payments was "on account of," and what portion was interest, held back wider use of periodic payments. In 1983, Public Law 97-473 amended section 104(a)(2) to clarify that the full amount of a structured

settlement's periodic payments constituted damages free from federal tax liability. This includes the annuity's inside build-up. Second, federal law also established IRC Section 130 to facilitate periodic payments by allowing the periodic payment obligation of the defendant and its casualty insurer arising from settlement of the tort claim to be assigned to a third party. This allows the defendant to obtain a full release and close its books on the claim and the periodic payment liability. Thereafter, in 1997, in the wake of the great success structured settlements had resolving claims in tort cases, federal tax law was amended again to expand the use of structured settlements to workers' compensation cases.

As a result of these laws, there is a near limitless ability to tailor a future payment stream to meet a claimant's living and medical needs. Among the advantages this provides claimants is the ability to focus on rehabilitation without worrying about the burdens of managing a large lump sum payment. In addition to being exempt from state and federal income tax, these payments offer exceptional security as federal law mandates that payments be funded by two of the most financially secure funding sources available—life insurance company annuities or U.S. Treasuries. Finally, because the full amount of the periodic payments is considered tax-free damages for the claimant, the after-tax returns to the claimant can be financially attractive compared with taxable equivalents (net of management fees).

## The Problem with All-Cash Negotiation

**Actual case:** A mother was suing a defendant that was partly at fault in a wrongful death action involving her

daughter. The mother was adamant that she would not accept less than \$1 million. She saw anything less as an affront to her daughter's memory. The defendant, believing such a sum was unwarranted given lack of complete liability, was offering slightly more than half that amount.

**The solution:** During negotiations, the mother allowed that she had a concern over who would care for her during retirement. She had planned on having her daughter there to care for her. The defendant's counsel and structured settlement broker worked with her on a stream of deferred payments, including larger lump sums, beginning near retirement to pay for living care. The payment stream over 20 years came to about \$1.2 million, but the cost to the defendant was within its targeted range for the case.

To paraphrase an old saying, pretrial negotiations are like a Kabuki dance without the spontaneity: Plaintiff attorneys lay out damages and indignities allegedly suffered by their clients, as well as chronicling the defendant's alleged negligence. In turn, defense attorneys raise exculpatory evidence and refute the plaintiffs' contentions. After that, both sides give a little ground while evaluating the other's willingness to go to trial.

In this process, the major flaw with all-cash negotiations becomes readily apparent: *When you negotiate solely with cash, your counteroffers inevitably must involve more cash.*

By contrast, the structured settlement tool offers an entirely different way to think about the case. By matching payments with future needs, the periodic payment arrangement of a structured settlement helps both parties focus on appropriate compensation, adding a dose of reality to an arbitrary damage claim. The inherent time value of money provides you with the opportunity to create different payment streams that may be more valuable to the plaintiff without necessarily incurring additional expense for your client. Finally, since the full amount of a structure's periodic payment stream is

tax-free—including effectively the investment earnings or time value of money component—the same claim value that the defendant might offer as a lump sum can produce a much greater total payout under a structure. This is why periodic payments have effectively bridged differences during negotiations.

Before discussing how to incorporate structured settlements into negotiations, defense counsel should understand that

### **The structured settlement tool offers an entirely different way to think about the case.**

the term “structured settlement” can refer to numerous payment plans reflecting the diverse needs of, say, a brain-damaged child or a 50-something plaintiff who lost his or her breadwinner spouse in a wrongful death accident. A few of the more common structured settlement payment plans include:

**Period certain.** This is a straightforward payment stream in which the defendant agrees to fund payments lasting a defined time, such as 10 or 20 years, to help the claimant recoup lost earnings or meet ongoing medical needs. A period certain structure is appropriate when the claimant does not suffer permanent damage and the scope of his rehabilitation is unlikely to change. These payments can be in equal amounts or can include cost-of-living adjustments, stepped payment increases and/or future lump sums.

**Life.** In cases of permanent damage, plaintiff counsel is likely to insist on payments guaranteed for the claimant's life. Life structures can include payment increases at regular intervals and occasional lump sums to allow for greater flexibility in meeting living and medical costs. A structure for the rest of the claimant's life will provide assurance to the family that the claimant will not outlive his or her money. It is particularly useful when the injury victim is a child with a

disabling injury, and the parents are concerned about who will care for the child once they are gone.

**Joint life.** Similar to a “second to die” insurance policy, a joint life structure keeps paying until both the claimant and the claimant's designee are dead. This is particularly appropriate for spouses who want to ensure their retirement security—for example, a severely injured husband who wants to make sure his wife has financial security in her later years.

**Life with period certain.** In recent years, plaintiffs have increasingly demanded minimum guarantees (often 10 to 20 years) attached to their life structures. Should a claimant die before the minimum pay-out, the remaining payments can be made to beneficiaries such as a spouse or child. This form of structure can be a useful tool for reassuring the claimant's family that even if the claimant were to die prematurely, the family would receive appropriate compensation. Alternately, the settlement can include a commutation that upon death will convert unused payments into a lump sum. Note: Joint life with period certain is also a common payment stream.

**T**here are numerous other examples of structured settlements, but the ones listed above are probably the most common.

### **Leveraging Your Advantages**

**Actual case:** A 16-year-old girl was shot while eating lunch in her school cafeteria. There were multiple defendants. Three years later, she settled with one defendant for about \$100,000. At the time, the girl had a newborn child and a much older boyfriend, who befriended her after the accident. That settlement was soon exhausted. The girl, her boyfriend and the girl's mother were pushing the main defendant, the school district, for a settlement sufficient to support not only the girl, but also her child. Separately, the defense attorney found out that the mother had concerns about the boyfriend's desires on the settlement.

**The solution:** The case was resolved within the school district's targeted range through a structured settlement. Structured settlements allow a claimant to build protections into the settlement agreement (and/or into a court order in the case of a minor) against others gaining access to the payments. Defense and plaintiff consultants designed a payment stream to support the girl's and child's medical and living needs. The girl's mother became a quiet advocate for settling with a structured annuity, which helped resolve the case.

In this section, we will explain a few ways to use the benefits that federal law grants to structured settlements to help create a more attractive financial settlement prior to trial.

As noted, all-cash negotiations by their nature offer limited flexibility. The response from the other side will always be the same: "More." The key is to shift the claimant's focus away from arbitrary dollar amounts and toward an enumeration of actual upcoming needs. By enumerating in detail all the claimant's upcoming medical and living expenses and then showing how a structured annuity payment stream meets those expenses, you can help create a settlement that is more "real" to the claimant—and therefore more difficult to walk away from.

Consider a few examples in which including a future payment stream as part of a settlement can add value to the plaintiff at no cost to your client:

**Integrate with other income and insurance sources.** Payment streams can be tailored to take account of shifts in other income sources, thereby maximizing income to the plaintiff. For example, if a plaintiff is 51, your payment stream can include larger payments for the first 11 years, with a reduction thereafter because the claimant will turn 62 and will begin receiving Social Security payments. If the accident victim is a minor, the parents' health insurance will likely cover medical costs until the child reaches maturity. Your settlement payments for medical care can then begin, with the benefit being that the

funding annuity will have compounded tax-free for several years.

**Ease retirement fears.** America's corporate pension plans are dangerously overextended, creating what one business magazine termed "the pension time bomb." A claimant in his late 40s or 50s is likely to see significant value in a plan that defers monies to retirement age tax-free and provides a payment guarantee that pension plans cannot match.

**Protection against creditors and divorce.** If the claimant or his or her family encounters unrelated financial difficulties, depending on the applicable state exemption statute, structure payments may offer many claimants significantly greater protection against creditors than cash and will therefore be more appealing. Likewise in a case involving (for example) an injured wife who believes her husband will file for divorce after the settlement, a structured payment stream offers greater ability to maintain control over her injury compensation. The same might be true when the claimant is a minor and one spouse believes the other cannot be trusted with a lump-sum settlement.

**Avoid probate.** Structure payments automatically bypass probate court if there are designated beneficiaries. Lump sum settlements, by contrast, will be subject to the often lengthy probate process. Therefore, if you have a wrongful death case involving a husband in his mid-50s, you can provide a life structure with a guaranteed minimum payment stream and occasional lump sums to ensure that the wife has funds for the rest of her life. If the mother should pass on before conclusion of the minimum payment stream, children who are named as designated beneficiaries will be able to receive the payments without probate delay.

**F**rom these examples, defense counsel should realize two things. First, structuring payments often creates a more attractive settlement offer than straight cash. Second, as with other aspects of litigation, designing payments is a specialized service. If you decide to incorporate

a structured settlement in your negotiation, you will likely be working with a structured settlement broker. This person is typically a financial specialist who reviews claimant's medical and economic records and then works within your settlement parameters to design a payment stream for the claimant. (This will not be an added expense to either you or to your client. Brokers are paid on commission from the life insurance company that sells the funding annuity.)

A word about structured settlement specialists: A trustworthy broker can be a valuable resource, particularly if negotiations near the breaking point. An experienced broker can show you ways to make your payments more valuable to the plaintiff or resolve concerns the plaintiff may have. In our experience, some defense counsel use the structure broker solely as an internal advisor, preferring to keep him or her away from the plaintiff. This seems short-sighted, since the more the broker understands of the claimant's needs, the more likely that he or she can design a payment stream to pique the claimant's interest. Many brokers frequently attend mediations and settlement conferences and have developed negotiating skills that may help settle the case.

Finally, plaintiff attorneys increasingly are retaining their own structure broker to advise the plaintiff. By involving your own specialist, you will continue protecting the defendant and insurance carrier that would fund any annuity plan. Structure brokers can also be useful intermediaries in helping to continue negotiations that may seem to have reached a deadlock. This also provides another way to resolve cases without a trial.

### **Preparing the Offer**

**Actual case:** Two granddaughters were providing all the financial and health support for their 80-year-old grandmother following her accident. The generation between granddaughters and grandmother was deceased. The granddaughters wanted guaranteed income for their grandmother's care without the concern over dissipating a lump sum settlement.

They wanted security that there would always be money for her care, so they were demanding a huge settlement which likely would have subjected them to estate taxes after the grandmother's passing.

The solution: A lifetime structured settlement for the grandmother with a long (30 year) guarantee that virtually ensures she will not outlive the guarantee period. The payment stream addressed the granddaughters' concerns about meeting their grandmother's continuing expenses. Upon the grandmother's passing, the unused payments from the guarantee period converted into equal lump sums, which bypassed probate and went directly to the granddaughters. The granddaughters agreed to settle for an amount acceptable to the defendant that also did not subject them to estate taxes.

This section will discuss specific ways for defense counsel to use structured settlements to facilitate settling cases within the client's target range. As you begin preparing for negotiation, one of your first tasks likely will be to analyze economic reports from the plaintiff and the carrier. We have often found it helpful to have your side's structure broker analyze both reports for respective strengths and weaknesses. A good broker will have experience in this and may be able to make useful suggestions. (As noted, since brokers work on commission, this will not create an additional expense for you or your client.)

Many injury cases involve the claimant putting forward a detailed plan for medical, rehabilitation or life care. This goes beyond the economic reports and is your guide to damages that the plaintiff might "blackboard" at trial. In effect, it presents a cap on the amount that plaintiff might demand for future medical care costs.

It may be helpful to price out this plan with a structured annuity. Doing so can give you insight into the plaintiff's potential recovery and also how that recovery is impacted by interest rates and mortality expectations. You can also determine areas of the plan covered by government benefits or private resources. Using this knowledge, you will be in a better position to direct your client's settlement resources to other aspects of the settle-

**Structuring payments often creates a more attractive settlement offer than straight cash.**

ment. (A structure broker who understands the impact of government and private resources can design an annuity payment stream incorporating these benefits. He or she may also be of help with your negotiation strategy.)

A creative use of structured settlements, such as outlined in the cases above, may be able to provide many of the requirements of the life care plan at a cost that is within your client's settlement range.

Any case involving a lifetime payment plan or serious injury should raise the issue of the claimant's rated age, which is an insurance company's projection of the claimant's likely life expectancy. Companies use this to calculate the annuity cost of funding a pay-out stream. Therefore, you will want to secure the best possible age rating for the claimant. For example, a 40-year-old with traumatic brain injury might be given a rated age of 60, meaning his life expectancy matches that of a typical 60-year-old.

To obtain an age rating, your structure broker submits medical information about the claimant to life insurance underwriters. This generally includes a hospital summary or an independent medical exam. Very important: Your age rating request should include *any* information that may reduce the claimant's life expectancy, *even if it is unrelated to the accident*. This could include such issues as the claimant being diabetic, a smoker, or having a family history of cancer.

The life company analyzes this material and assigns the age rating. As the table at the bottom of this page shows, age ratings can be critical to settling your case because the higher the rating, the greater benefit payments for the same settlement amount. This table shows the monthly payments you can guarantee to a 40-year-old claimant who suffered traumatic brain injury based on a hypothetical \$1.5 million settlement available. Note that even a relatively small rating change from 70 to 75 significantly affects the payment stream.

If your case involves workers' compensation, you may find it helpful to incorporate structured funding with your Medicare set-aside allocations (MSAs). An MSA is created when settling a workers' compensation or similar liability case. It is funded with a portion of the settlement designed to compensate the claimant for future medical expenses stemming from the accident that otherwise would be paid by Medicare.

By funding the claimant's MSA with a structure, you can establish a regular payment stream for medical care that cannot be prematurely dissipated. That may be particularly attractive to an injured worker. Moreover, since the Administrator is responsible for filing annual reports with Medicare to account for every dollar spent, Medicare looks favorably on structure funding. For workers with injuries requiring long-term care, you should be able to leverage a tax-exempt structured annuity to fund these expenses for a competitive amount. This may allow you to add additional funding to another part of

Rated Age	Monthly Payment Guaranteed for Life*	Increase Over Standard Rating Payments
40 (Standard rating)	\$7,400	N/A
60	\$9,400	27%
70	\$12,300	66%
75	\$14,800	100%

\*Payments are for life with no minimum guarantee and based on current rates.

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the settlement while still staying within your client's targeted settlement range.

Finally, there has long been discussion within the defense bar about whether to reveal to the claimant the cost of a structured annuity. U.S. Treasury regulations are clear that divulging such information will not compromise a claimant's right to place the funds in a tax-free structured annuity ("[I]ncome is not constructively received if the taxpayer's control is subject to substantial limitations."). Moreover, with such cost information readily available to the plaintiff, a refusal to reveal the cost is simply likely to raise unnecessary suspicions.

That said, as is noted in the excellent book *Structured Settlements & Periodic Payment Judgments*, "A legitimate concern exists if the plaintiff settles on cost first and then directs the type of annuity which is to be purchased. In such cases there is, arguably, control, hence a question of constructive receipt."

### **Post-Verdict Negotiation**

The nightmare happens. A case that should have settled out of court for, say, \$500,000 goes to trial and the jury returns a verdict of \$2.5 million. With the threat to appeal,

the defense has not lost all its negotiating power, but the negotiation dynamics have changed.

Since a lopsided verdict typically exceeds the defendant's primary limits, one of the first results is often involvement of the excess insurance carrier, who will press for a new legal strategy in the hope of mediating a new solution.

If you are on the defense team, it may be helpful to incorporate a structured annuity settlement into your strategy, particularly if it was not discussed during pre-trial negotiations. By offering a structured settlement, you can confer a benefit to the plaintiff (tax-free income over time) that cannot be obtained on his or her own. Remember that in most instances, the plaintiff will be keen to settle the case. The thrill at a massive verdict will be quickly tempered by angst about a reduction or overturn on appeal and a lower net after expenses and contingency fees.

Finally, if you do use a post-verdict structure, then prior to settlement it is important to file notice of appeal or motion for a new trial. Another option is a "compromise and release" agreement that vacates the judgment. The case can then be settled as a disputed claim to ensure that the plaintiff is not

deemed by the IRS to have taken "constructive receipt" of the settlement.

### **Conclusion**

The foregoing discussion of structured settlements is not meant to be a seminal study of the product or its usefulness to defense counsel. Instead, it is meant to provide a sense of the difficulties with all-cash negotiation and an overview of the negotiating benefits of periodic payments. The severity of the injury, the nature of the litigation (several defendants or just one) and degree of liability will impact your decision to involve periodic payment settlements as will the needs of the claimants.

At its essence, a structured settlement is an additional means of settling a difficult case prior to trial within the client's financial parameters. From the defense counsel's perspective, this is a salutary outcome. It serves the client's needs and mitigates the risk of runaway juries.

Also not to be overlooked, with insurers increasingly moving away from retaining defense counsel on an hourly basis and instead using flat-fee or retainer agreements, alternatives to lengthy pre- and post-trial negotiations can also have beneficial financial implications for the defense firm. **FD**