U.S. Department of Justice

Civil Division

Washington, D.C. 20530

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MEMORANDUM

TO: FTCA Staff, Assistant United States Attorneys, and Agency Counsel

FROM: Jeffrey Axelrad
Director, Torts Branch
Civil Division

SUBJECT: Federal Tort Claims Act Settlements

I. Structured Settlements [1]

A. Introduction and Overview

The term "structured settlement" is generally used to describe several types of non-lump sum payments to personal injury claimants. Each of the more common "structured settlement" formats and typical variants are discussed under Section II below. As witnessed by the plethora of bar journal and other articles,[2] structured settlements are by no means new to either the personal injury bar or, for that matter, the Torts Branch.[3]

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[1] See Attachment A for levels of settlement authority dealing with FTCA claims and suits.

[2] See e.g., Brelowski, "Structuring Settlements," Trial, June 1983, at 47; "Something For Everyone," Forbes, January 19, 1981, at 29; Danninger, Johnson & Lesti, "Negotiating A Structured Settlement," 70 ABA Journal, May 1986, at 67.

[3] See, Hindert, D.W., Structured Settlement and Periodic Payment Judgments (Law Journal Press, 1986) Chapter 3, § 3.08 at 3-37.

The reasons and relative merits for using one or more of the structured settlement approaches in lieu of a lump-sum settlement may vary from case to case. In some instances, a structured settlement may be inappropriate or financially disadvantageous. The purpose of this memorandum is to provide basic information concerning the form, mechanics, application and cost of the major structured settlement formats.

B. Structured Settlement Formats

1. Irrevocable Reversionary Trust

a. Reversionary Medical Trusts

Our initial experience with structured settlements involved reversionary medical trusts. These trusts were initially limited to medical, hospital, and institutional expenses. Subsistence costs have been included as allowable expenses in some instances.

The underlying justification and reasons for using a reversionary trust are basically two-fold. First, in cases with uncertain life expectancy or medical expenses, a trust provides an essential, guaranteed fund of money for the payment of enumerated future medical costs and expenses, while at the same time avoiding a "windfall" to the estate of the beneficiary. In addition, the trust minimizes the risk of dissipation of settlement proceeds, particularly, for example, in the case of severely brain-damaged parties.

Second, a reversionary trust is financially beneficial to the government. In many cases, the cost to the government may be less than a lump-sum cash payment for significant future medical costs and expenses which may or may not be incurred depending on the claimant's survival. In addition, the government retains a reversionary interest in the corpus and unused accumulated earnings.

There may be disadvantages to using a reversionary trust in some instances. In several cases where the trust authorized payment for expenses beyond medical care, such as discretionary payments for the "general welfare" of the beneficiary, administrative problems have been experienced. Predictably, disputes have arisen either between the beneficiary (or guardian) and the trustee, or between the trustee and the government in terms of the appropriateness of certain expenditures. In addition to increasing the annual costs of administration, some resources are required for the review and examination of periodic transaction statements as well as for responding to inquiries regarding expenditure requests made by the beneficiary. Finally, where a trust is used for lost earning replacement, the investment earnings of the trust may become exposed to state and federal tax liabilities, thereby diminishing the anticipated value of the government's reversionary interest.

"Special Needs Trusts"

Recently, a number of plaintiffs' attorneys have requested that our model trust agreement be revised to assure that trust assets not be deemed available to the beneficiary under the Social Security rules and regulations. The requested modifications are apparently designed to make our model qualify as a "special needs" or "supplemental needs" trust under the Omnibus Budget Reconciliation Act of 1993. An essential requirement of the Act is that the special needs trust preserves the right of medicare or medicaid to have a reversionary interest in the trust up to the value of its lien for payments made to or on behalf of the beneficiary. Generally, the model reversionary trust should not be modified to make it qualify as a special needs trust; while the beneficiary's right to reimbursement from the trust might thereby limit his or her right to reimbursement from other sources, the economic incidence of the benefits is thereby recognized fairly and other governmental programs are not tapped unnecessarily. If you have any questions, please call the Torts Branch.

New Model Reversionary Trust

We have extensively revised the model Irrevocable Reversionary Inter Vivos Medical Trust agreement. The new model is to be used for any FTCA claim or suit settled with a trust.

Modification to Article II.A.3.b (the list of allowable benefits) will be necessary. We have intentionally left this section blank; the precise list of allowable benefits must be negotiated by the parties.

Other types of provisions that may be considered are noted in the model trust. For example, the model authorizes the trustee, in its discretion, to use an administrator. However, where the parties or the trustee insist on the appointment of a particular medical administrator to assist the trustee in administering the trust, provisions in the model need to be modified to reflect the appointment of a named administrator.

With minor modifications, the model can also be used in settlements where the United States does not have a reversionary interest in the trust.

Substantive changes should not be made without prior consultation with the Torts Branch.

2. Periodic Payments

a. Overview

There are basically two types of investment vehicles used to produce future periodic payments: annuities and government securities. Annuities purchased from life insurance companies provide a broad spectrum of options for periodic or scheduled payments which, unlike reversionary trusts, require virtually no further administrative involvement by the government. Various forms and permutations are available: straight-life annuities,[4] life annuities with guaranteed minimum payments,[5] and deferred annuities.[6] Periodic payments (e.g., monthly, semi-annually, or

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[4] As its name implies, this type involves a life contingency so long as the annuitant lives, the insurer continues to make the specified periodic or other scheduled payments.

[5] Unlike the straight-life annuity, life annuities with guaranteed minimum payments are contractually guaranteed. In the event of the annuitant's death, payments of a specific amount and period of time are paid to the estate or other specified beneficiary. In many cases, the additional cost of providing a guarantee is relatively modest.

[6] Payments are delayed for a specified period of time after which a specified flow of payments is made. As such, the delay element provides the insurer with a period for investment accumulation, thereby reducing the annuity cost.

annually) can be constant or increasing at a predetermined rate to offset inflation and can be based on one or two lives (joint and survivor basis).

The following examples are illustrative of the usefulness of periodic or scheduled payments:

1. Plaintiff, a severely injured child with a normal life expectancy, requires lifetime care and support together with financial management support. In addition to providing increasing periodic payments commensurate with the projected life-cycle needs, deferred payments (e.g., lump-sums in 5-10-15 years) paid into a reversionary medical trust, for example, could be used to meet the plaintiff's requirements.

2. "Substandard Life" - Where the plaintiff's predicted life expectancy is arguably less than normal life expectancy (based on standard mortality tables), it may be possible to achieve a significant or indeed substantial premium cost reduction from a life insurance company.[7] In this regard, it is

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[7] Several caveats or problems emerge in regard to substandard life annuities. First, because insurance companies generally rely upon their own actuarial experience, mortality rates may vary considerably from carrier to carrier.

Second, actual life expectancy data is generally unavailable with respect to many serious health impairments and significant variation exists among medical experts. Using the quadriplegia case as an example, some insurance carriers refuse to factor in a shortened life expectancy because of their own limited experience and lack of hard statistical data, while others have acknowledged a significant reduction. In many cases, the task of persuading an insurance carrier (and initially its medical officer) of an increased mortality risk rests upon the shoulders of the annuity broker and defense counsel. Thus, in a case involving a rare disease or injury, a survey of scientific literature and the preparation of a medical expert consultant's opinion could result in a significant cost reduction or, alternatively, expanded benefits at the same cost.

Third, an insurance company may have written nearly its quota of substandard life annuities and may not be actively seeking additional business, while another company may be eager to engage in the underwriting of these risks. The willingness of important to note that life-based annuities are usually underwritten by insurance carriers on the basis of sex, race and attained age which in turn determine life expectancy (actually annual mortality rates). Accordingly, substandard ratings are usually expressed in terms of increased percentages of normal mortality (or increased attained age). Thus, for example, a 20-year-old quadriplegic might be designated as being 35 years old for underwriting purposes. Similarly, a brain-damaged infant might well be "ra[illegible] as the same age as an elderly person. Rated ages are not available with government securities.

3. A recovery of a set amount is desired to make a settlement attractive to a plaintiff, but the timing of receipt is negotiable, or eventualities (such as retirement or college education costs) will call for substantial sums to be drawn in the future.

b. Annuity Purchase

i. Annuity Brokers

Few, if any, insurance carriers will sell a settlement annuity directly to either the annuitant or defendant.[8] The industry standard of practice requires the use of a licensed broker or insurance agent.[9] As a practical matter, although the agent or broker's fee or commission received from the insurance carrier is ultimately passed on to the purchaser and is

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a company to rate an individual at a favorable substandard age is influenced by these factors.

[8] The settling defendant, here the government, ordinarily becomes the actual owner of the annuity contract. Were the plaintiff-annuitant to acquire ownership, as well as the beneficial interest in the annuity, adverse tax consequences might occur and an important benefit and negotiating point might be lost. As is mentioned in the body of this Memorandum, government counsel should make <u>no</u> representation regarding tax consequences; however, government counsel may suggest that a party consult with a tax advisor.

[9] Typically, government securities are also purchased through a broker.

invariably reflected in the premium cost quotation (see, subsection ii below), an effective agent can provide valuable services and advice. In the case of a potential substandard life annuity, the agent should be familiar with the variable underwriting practices of the insurance companies and the proclivities, biases, or other tendencies relative to mortality. Additionally, annuity rates may vary from week-to-week or month-to-month depending on interest and investment return rates. Finally, most annuity brokers will, without charge, attend and participate in negotiation sessions, thereby ensuring greater flexibility and immediacy in the calculation of changes in the structured settlement package and the availability of reassuring information in response to questions or doubts expressed by opposing counsel. You should not agree to defray any of the broker's costs and expenses since these costs of doing business are recouped from annuity settlements that are consummated.

The selection of a broker is left to the discretion of the government attorney handling the settlement. The Torts Branch does not keep a list of brokers and we do not approve brokers. The Department of Justice's policy regarding the selection of brokers is attached at Tab B.

ii. Annuity Premium Costs

The purchase cost of an annuity, whether life-based, guaranteed or deferred, will generally include acquisition, premium, and administrative costs in addition to a "profit-load" factor for the insurance carrier. In addition, state premium taxes, ranging from 1 to 2.5 percent, are imposed by a few states.[10] Acquisition costs represent the commission paid to the agent or broker and general agent. Typical commissions are 4.0 percent of the premium. The insurance carrier's administrative expenses are typically calculated at a one percent differential between gross and net investment yields. Needless to say, net yields vary from company to company thereby resulting in

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[10] Uniformity in the imposition of such tax does not exist. Some insurance carriers use the residency of the annuitant to determine tax liability, others the residency of the owner or purchaser. So long as an insurance carrier is consistent, state tax authorities apparently have not challenged the resulting disparity.

considerable cost variation in large annuities, especially where other variables, such as increased mortality, are present.

C. Tax Considerations

An important consideration for any settling plaintiff is the tax consequences of a lump-sum settlement versus a structured settlement. Although lump-sum tort settlements or judgment payments are not income and not subject to income tax,[11] interest or other investment earnings derived from a lump-sum settlement fund are subject to normal tax consequences. Annuity payments and income earned in reversionary trusts are exempt from tax liability so long as there is neither constructive receipt of the purchase cost nor ownership vested in the annuitant.[12] Thus, even though the flow of annuity payments will include the distribution of some investment earnings by the insurance carrier, the payments appear to be exempt from taxation. This is an important negotiating point. Conversely, the availability of a tax-free lifetime series of annuity payments, for example, should not be conferred on a plaintiff without an offsetting benefit to the government: that is, an adequate quid pro quo. You should be aware of all of the government's interests and take them into account when you negotiate a settlement on behalf of the United States.

It is essential that you make no representations as to the tax consequences of a settlement. Such matters are for plaintiff's counsel to assess along with the broker, if any, and, ultimately, for the Internal Revenue Service to determine.[13] You should, of course, be aware of probable tax consequences so that

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[11] Section 104(a)(2) of the Internal Revenue Code excludes from gross income "the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness." See generally, Yor..: The Taxation of Damages: Tax and Non-Tax Policy Considerations, 62 Cornell L. Rev. 663 (1977).

[12] See, I.R.C. § 204(a)(2) (West 1985); see also, Revenue Rulings 77-230 and 79-220.

[13] This is especially important since tax liabilities affect the Treasury just as do FTCA settlements and judgments.

the United Sates may obtain value received for the anticipated tax benefits as part of any negotiated settlement.

D. Special FTCA Considerations

Because of statutory, administrative, or other considerations, structured settlements require special attention to the following:

1. Under 28 U.S.C. § 2678, an attorney's fee is limited to either 20 percent (administrative claim settlement) or 25 percent (settlement of a lawsuit). Accordingly, the question of attorney's fees occasionally arises in connection with a structured settlement utilizing an annuity. As a matter of interpretation, logic, and common sense, the maximum attorney's fee must be calculated on the basis of the total payout or cost to the government at the time of settlement. In several instances, attorneys have attempted to argue that their fee should be based on either the investment taxed judgment value equivalent or the total annuity payout. Neither approach is appropriate or legally viable. With respect to an annuity, the actual cost, by definition, represents the present value of the flow of periodic or other scheduled payments. See, generally, Wyatt v. United States, 783 F.2d 45 (6th Cir. 1986).

2. A private defendant or its insurer usually "guarantees" periodic or other scheduled payments. There is no legal authority for such a guarantee on the part of the government, and statutory requirements mandate that settlements forwarded for payment certify the finality of the claim. See, 28 U.S.C. § 2414. The insurance industry and many litigants want to enter into "qualified assignments." The United States should not agree to a qualified assignment unless the assignment contract is modified to make clear that the government has no obligation to assign. However, we do not object to the insurance company assigning its obligations

3. Unless the parties specifically negotiate a structured settlement, the settlement is presumed to be for cash only. Government counsel should not agree after the fact to structure a settlement that was based upon a cash only payment or authorization to settle for cash. The Attorney General or her designee almost always specifies that settlement authority is

conditioned upon a cash settlement or a structured settlement. Accordingly, government counsel handling the settlement is without authority to change the terms of the settlement after the Attorney General or her designee has acted upon the request for settlement authority.

II. Stipulations for Compromise

The stipulations for cash and structured settlements have been revised. **Substantive changes should not be made without prior consultation with the Torts Branch.**

III. Payment Forms and Procedures

Each request for payment of settlements must include standard Treasury forms and a copy of the stipulation for compromise settlement (or a Form 1145 for some cash administrative settlements). Treasury forms and answers to commonly asked questions are available at www.fms.treas.gov/judgefund/index.html.

IV. Sources of Information

If you have any questions or suggestions, please contact the Torts Branch. Within the Torts Branch, Assistant Director Roger D. Einerson (202 616-4250) has acquired considerable expertise and experience in dealing with structured settlements and with settlement documents in general. He has been designated as a point of contact on structured settlement matters.

Finally, please consult with us before you seek to negotiate a substantive change to the model trust or model stipulation for compromise beyond those variations that are outlined above or in the footnotes to the models.

Attachments