FIDUCIARY FOCUS

The Prudent Integration of Structured Settlements and Post-Settlement Trusts

By Henry L. Strong and David M. Cordell

Despite legal expertise and years of experience, many attorneys and judges must stretch to provide sufficient economic scrutiny of structured settlements and post-settlement trusts. The reason is simple: They have not had sufficient training in modern finance. Unfortunately, this knowledge gap may result in settlement fiduciaries failing to live up to prudent standards of care, skill, and caution or failing to consciously determine the trade-off between the risk and return of a settlement plan, the central consideration of all modern fiduciaries. Either kind of failure can lead to unintentional and unnecessary exposure to liability.

This article outlines key distinctions between structured settlements and post-settlement trusts, articulates how these differences affect returns on a risk-adjusted basis, and demonstrates how a thoughtful integration of both can deliver vastly superior results over those obtained by either vehicle alone. By clearing up the confusion over how best to allocate settlement proceeds, we hope not only to assist members of the bar and judiciary but also to materially aid injured claimants. We conclude the article by offering practice tips to help avoid problems.

A Troubling Reality

Continual innovation has substantially improved settlement planning options for injured claimants. Despite numerous advances, however, many trial courts across the country continue to approve settlement plans that would make fiduciaries of 401(k) plans and other retirement programs cringe. What could provoke such discomfort? Gross breach of the standard of care, for one; fundamentally flawed risk-return allocations, for another. If this sounds extreme, it is only because most settlement fiduciaries are not used to thinking in these terms, while fiduciaries of retirement plans live and breathe them every day.

Yet even many professional fiduciaries have trouble understanding the nuances of the ever-more sophisticated financial products they must assess. Unnecessarily complex products too easily divert them from bedrock principles of financial prudence into high-fee, low-value schemes that cost beneficiaries dearly. Few fiduciaries know how to uncover all the layers of hidden fees, buried costs, and troublesome conflicts of interest that plague so many of these products.

Although it is difficult for ordinary consumers to make sense of such products, it is another matter entirely when fiduciaries make formal recommendations in a courtroom. Consumers are allowed to make unsound financial decisions; fiduciaries are not.

When settlement fiduciaries make flawed financial decisions in this context, the problem generally is not a failure to scrutinize but a failure to scrutinize appropriately and fully. Fiduciaries may give proposed settlements a thorough examination from the standpoint of legal sufficiency,[1] but they often pay surprisingly little attention to economic sufficiency. (By "economic sufficiency" we refer not to the size of the overall recovery[2] but rather to the prudent process by which recovery assets are actually conveyed to the injured party and then invested and managed over time.)

Nowhere is the failure to sufficiently scrutinize economic sufficiency better illustrated than in the ongoing debate over which is better, a structured settlement or a post-settlement trust. In fact, the two are so dissimilar that to pose this question in the first place reveals the very financial inexperience that stands to harm beneficiaries. The proper

© 2008 by the American Bar Association. Reproduced by permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

question is not which should be used but rather how much of each is appropriate in a given case. To fulfill their fiduciary responsibility prudently, attorneys and judges need substantially more education before they can strike the right balance between a structured settlement and a post-settlement trust.

Modern Portfolio Theory and Modern Settlement Theory

The core dynamic at issue in the structured settlement versus trust debate parallels the most profound money-management advance of the past century: modern portfolio theory. This was the discovery that building a portfolio of assets with uncorrelated returns not only reduces overall risk but can actually increase overall return.[3] Modern portfolio theory earned its developers a Nobel Prize and has been empirically supported beyond any serious challenge.[4] It therefore stands as the bedrock strategy for all fiduciary investing.[5]

Viewed against this backdrop, the flaws in the "either/or" argument become clear. Choosing only a structured settlement or only a post-settlement trust will almost certainly increase overall risk and reduce returns—exactly the opposite result fiduciaries are obligated to seek for beneficiaries. In many cases, the sensible choice will be a thoughtful integration of the two. We might call this "modern settlement theory"—the discovery that blending dissimilar settlement distribution methods not only reduces risk but also increases returns for injured claimants.[6]

Henry L. Strong, *President of JMW Settlements, Inc., in Washington, D.C., is a Certified Structured Settlement Consultant and an Accredited Investment Fiduciary. He can be reached at Henry.Strong@jmwsettlements.com.* **David M. Cordell**, *Director of Finance Programs at The University of Texas at Dallas, holds a doctorate in finance and the Chartered Financial Analyst, Certified Financial Planner, and Chartered Life Underwriter designations. He can be reached at David.Cordell@utdallas.edu.*

Key Allocation Considerations

Beyond risk and return, prudent fiduciary decision making requires contemplation of a broad array of considerations, but the most important by far are diversification, taxes, fees, and liquidity.[7] All other considerations pale in comparison. A typical tendency, though, is to focus on return, sometimes to the exclusion of all else. Yet because these other factors affect return, they are each critical to the process. Luckily, structured settlements and post-settlement trusts cleave fairly cleanly along these lines of consideration. Once the differences are understood, fiduciaries with ordinary financial experience become perfectly able to craft intelligently allocated plans that offer vastly superior value.

We also recognize, of course, that real-world conditions limit the amount of time, attention, and experience that attorneys and judges can commit to this task. Given these conditions, one must engage in a form of financial "triage": it is more important to get the big things right than the little ones.

Allocation Strategy Considerations

Given the fundamental differences between structured settlements and post-settlement trusts, the obvious prudent strategy is to allocate settlement funds in a way that maximizes exposure to each vehicle's strengths while minimizing exposure to its weaknesses.

Why such a heavy focus on prudent allocation prior to distribution? Because receipt of settlement funds by injured claimants is a tax-critical event.[8] Failing to recognize this key fact may expose settlement fiduciaries to significant breach of duty claims (so-called destructive receipt claims), as has already occurred in a number of jurisdictions.[9] Given the magnitude of the benefits injured parties might lose through such a blunder, harsh compensatory consequences are easily calculated and, frankly, appropriate. Education on this point serves as the first and best defense against such claims. In fact, the only way to protect yourself and beneficiaries from undue risk is to develop a solid understanding of allocation strategies and to employ them appropriately.

Because the income generated by a qualified structured settlement is completely nontaxable, the structure should serve as the primary investment vehicle. The post-settlement trust is then crafted around the structure to control cash distributions and manage supplemental investments.[10] The logic of this approach becomes more obvious as you consider each attribute in turn.

Taxability. Qualified structured settlements are nontaxable as a matter of law, but most post-settlement trusts are taxable entities.[11] Moreover, tax rates on trusts are accelerated compared to individual tax rates, reaching the highest federal rate of 35 percent at an annual income level of only $10,700.[12] Trust income not taxable to the trust is reported as income to the beneficiary and is subject to individual income tax rates. And though one may purchase nontax-

© 2008 by the American Bar Association. Reproduced by permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

able securities such as municipal bonds within the trust, such investments usually provide lower returns and may be short-lived, as call features can trigger early redemption.[13] Structured settlements are not subject to call features; all interest, dividends, and capital gains generated by a qualified structured settlement are tax-free for the duration of the scheduled payments.

Conditionality of payments. Trusts permit conditional payments that are governed by the terms of the trust instrument and are overseen by a "gatekeeper": the trustee. While many claimants have income needs that do not fluctuate widely, others' needs are not nearly so predictable. Trusts permit customized expenditure rules and grant trustees discretion to allow for changing circumstances. Structured settlement payments are made according to a fixed schedule that cannot be altered.

Liquidity. The importance of being able to convert an asset to cash must be considered in every case. Structured settlements are not liquid because the recipient cannot exercise control over the funding assets.[14] The liquidity of a trust, however, is limited only by the investment choices of the trustee (keeping in mind that greater liquidity generally comes at the cost of reduced investment returns). Cases demanding 100 percent liquidity or 100 percent illiquidity are somewhat rare. The settlement fiduciary should determine the required level of liquidity and design the plan to meet the beneficiary's needs, allocating assets appropriately between structure and trust.

Trust/custodial fees. To cover the costs of active administration, trusts incur annual fees, usually

Attribute	Structured Settlements	Post-Settlement Trusts
Taxable	No	Yes
Conditionality of Payments	Unconditional	Conditional
Liquidity	Limited	Yes
Trust/ Custodial Fees	None	Annual
Investment Options	Limited	Broad
Longevity Risk Hedge	Yes	No
Medical Underwriting	Yes	No

Green = more desirable | Orange = less desirable | Black = situational

based on a percentage of the value of the assets held in the trust. Passive structured settlements incur no such charges.[15] Bear in mind that the value of trust services is not insignificant: Trustees who assume fiduciary responsibility over the investment and expenditure of funds often confront difficult decisions regarding their distribution. Having a "gatekeeper" can be a real advantage. Still, annual fees reduce the net return on funds held in the trust, and they should be taken into account in the allocation of any plan.[16]

A recent Supreme Court case has unfortunately increased trust costs by denying the deductibility of investment advisory fees unless they exceed 2 percent of the trust's adjusted gross income.[17] While this makes trusts effectively more expensive, it may also make the examination of costs easier for fiduciaries, as trust providers may have to begin breaking these specific costs out of their bundled service packages.

Investment options. Trustees may invest trust assets in any class of investments permitted by the trust instrument. Most structured settlements may be funded only with U.S. government obligations or annuities from state-regulated life insurance companies.[18] At present, structured settlement funds can be invested only in fixed-income and diversified portfolios of large capitalization stocks (no small capitalization or international stocks, and no real estate investments).[19]

Longevity risk hedge. Investment decisions are often governed by duration: how you allocate funds between a structure and a trust depends upon how long you think the beneficiary needs income. A primary risk when investing funds for the benefit of single individuals is that they might "outlive their income"—the

© 2008 by the American Bar Association. Reproduced by permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

classic concern of retirees. The only investment vehicle that mitigates such longevity risk is a life-contingent annuity issued by a life insurance company, which makes payments until the beneficiary dies.[20] While such annuities can be purchased within a trust, it is far more advantageous to arrange lifetime payments within a tax-favored structured settlement.

Medical underwriting. Lifetime annuity payments, as noted, depend on life expectancy, usually that of the beneficiary. However, severe injuries or preexisting medical conditions (such as diabetes, cancer, pulmonary disease, cardiovascular disease, and drug or alcohol abuse) can reduce life expectancy, sometimes drastically. Using ordinary life expectancy tables to calculate future benefits for such a person would be inappropriate. Under these special circumstances, annuity issuers employ medical actuarial experts who will review medical records on a case-by-case basis. If conditions warrant, they may adjust (reduce) life expectancy assumptions and increase future payments at no added cost. In catastrophic injury cases, life expectancy reductions routinely produce increases in benefits of 30 to 40 percent.[21] And of course, the annuity issuer bears this risk entirely; should the beneficiary outlive the estimate, payments continue regardless.

Liability Exposure

The pursuit of higher returns at lower risk may form the center of every investment professional's universe, but a trial attorney's world spins on a slightly darker axis: liability. No one is suggesting that attorneys or judges need become what they are not: financial professionals. However, the skill set that makes trial attorneys successful in recovering damage awards for their clients—namely, the ability to identify liability in the midst of a complex series of events—can serve practitioners well in avoiding problems related to the distribution of settlement proceeds if they know what to look out for.

Destructive Receipt

For purposes of settlement, make certain you understand that the receipt of settlement funds can be a disqualifying event. Inadvertently allowing settlement proceeds to be distributed—either directly to your client or indirectly into a post-settlement trust or your law firm's trust account—before evaluating your client's post-settlement needs can mean big trouble.[22] It has formed the basis of litigation in multiple states and, because it may constitute an irreversible harm, is a particularly high-risk type of case to defend. Cautious attorneys need to know what is at stake and take affirmative steps to protect not only their clients but also themselves. Do not accept funds until an analysis of tax benefits and the preservation of government benefits have been fully considered.

Informed Consent

Few injured claimants know anything about tax and financial issues at settlement; neither do their parents, guardians, or friends. While there is no law that requires the utilization of either structured settlements or trusts in the resolution of a claim, there is an ethical requirement that attorneys explain matters "to the extent reasonably necessary to permit the client to make informed decisions regarding the representation."[23] If you permit the transfer of funds from defendant to plaintiff before your client has had the chance to consider the implications of that receipt, you may have breached a fundamental ethics rule.[24] Appointed representatives need to be made aware of these issues as well; guardians and guardians ad litem may be as exposed—or even more exposed—to liability than you are.

Involvement of Qualified Experts

If you are not trained to offer financial advice at settlement, you may wish to refer your client to someone who is. This could be considered an ethical requirement, and it makes no sense to offer a referral after distribution if distribution is a harm that you wish to avoid.[25] Instead, hire qualified experts and get them involved early so that you are not scrambling around at the last minute. Given the superior results available through a prudently integrated approach, it is wise to avoid overaggressive providers of either structured settlement or post-settlement trust products. At the first whiff of territorialism (urging one approach at the exclusion of the other), you would do well to fire that "expert" and hire another, someone with a proven track record of working productively with the many experts upon whom trial attorneys and their clients must depend.

When in Doubt, Assume You Have a Duty

Breach of an ethical duty may not necessarily impose liability (depending on the jurisdiction), but it is not an infraction most attorneys would wish to carry into the courtroom when defending a claim. More worrisome still is the

© 2008 by the American Bar Association. Reproduced by permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

breach of fiduciary duty. Attorneys accept that they owe a fiduciary duty to their clients as it relates to the delivery of legal services, but how far does that duty extend? Could it extend to the financial impact of the final terms of settlement and the handling of settlement proceeds? If so, attorneys might then be subject to the criteria set forth in the Uniform Prudent Investor Act.[26] Unfortunately, many trial attorneys are not sufficiently familiar with the Act, much less aware of its specific terms.

All this matters because the definition of "prudence" has been refined continually by the courts and by legal academics for over 100 years, resulting in a list of clear and unambiguous considerations that fiduciaries must consider when making decisions on behalf of beneficiaries.[27] Ignoring taxes and a beneficiary's "other resources" (e.g., eligibility for government benefits) would likely breach this standard.

Document, Document, Document

As experience shows, all the care in the world will not help an attorney who is unable to document the precautions taken in fulfilling fiduciary responsibilities. To meet legal and ethical standards, make precise notes about each step in the settlement process: fully informing your clients about the settlement process, referring them to experts as appropriate, and weighing the prudent investor considerations. And it goes without saying that trial attorneys should store all settlement-related documents in a safe place. The financial stakes are high, and they may extend many years into the future.

Conclusion

Settlement planning—and modern settlement theory, in particular—presents attorneys and judges with an extraordinary opportunity to capture added financial value for injured claimants without added financial risk. As a legal professional, you may therefore wish to invest the time to develop a sound understanding of where the greatest financial value lies in order to secure it for each client you serve. In settlement, as in prudent investing generally, thoughtful diversification remains king, and a careful integration of structured settlements and post-settlement trusts will often provide the best of all possible solutions. ■

Notes

1. Legal sufficiency refers to the capacity to act, authority to receive and manage assets, etc.

2. The primary issue in contention during claims resolution is the overall value of a settlement relative to the merits of the underlying claim. Focus on this issue alone has historically diverted attention away from the additional vital issue for claimants of which form of distribution will best serve them.

3. For purposes of analysis under this theory, risk is defined as volatility—the degree to which the actual return of an investment varies from its mean (average). *See* Harry M. Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952).

4. The 1990 Nobel Prize in Economic Sciences was awarded to Harry Markowitz, William Sharpe, and Merton Miller.

5. So significant was this development that it actually prompted an overhaul of the formal definition of prudent investing, leading to adoption of the *Restatement 3rd of Trusts* (Prudent Investor Rule and its progeny, the Uniform Prudent Investor Act). The two now stand together as the accepted standard of care for financial fiduciaries.

6. *See also* David M. Cordell & Joseph W. Tombs, *Planning Consideration for Personal Injury Settlement Recipients*, 18 J. FIN. PLAN. 26 (Jan. 2005).

7. *See* UNIF. PRUDENT INVESTOR ACT § 2(c)(1994).

8. Receipt of settlement proceeds may also affect eligibility for government benefits, an additional potential liability exposure.

9. Henry L. Strong, *Destructive Receipt: Hidden Ethics Risks Prompts Practice Adjustments*, 34 ADVOCATE 12 (Nov./Dec. 2006).

10. The structured settlement payments would usually be paid directly to the trust to ensure the desired trustee oversight. However, if the situation calls for it, a portion may be paid directly to a beneficiary, provided this would not disqualify the beneficiary from means-tested benefit programs.

11. Post-settlement trusts awarded for physical injuries or physical sickness qualify for full tax exclusion; those for nonphysical injuries (e.g., defamation or discrimination) are taxable but may qualify for tax-deferral if properly established in the settlement.

12. 2008 federal income tax rates.

13. A call feature allows bond issuers to redeem bonds prior to their maturity date, usually in return for a small premium over the bond's face value. This will typically occur when interest rates decline, making the issuance of new bonds at lower interest rates more favorable than continuing to pay interest on the old bonds at higher rates.

14. Actual receipt, constructive receipt, or economic benefit voids the tax benefit. Recently, certain finance companies have begun to offer "cash now" in exchange for a claimant's right to receive future payments, but in most jurisdictions such transactions must be approved by a court, and the effective interest rates have been harsh. Cashing in a structured

© 2008 by the American Bar Association. Reproduced by permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

settlement should be a last resort and reserved for bona fide hardship situations.

15. Clearly, the instruments used to fund structured settlements (usually annuity contracts) have costs built into them that affect the pure return to beneficiaries. However, these costs are built into the pricing; all fixed annuity benefits are quoted net of fees and are not reduced by further charges.

16. "Bundled" services—whether offered by a trust company or any other financial services company—present significant challenges to fiduciaries. In some cases they may present added value, as long as all services are needed and are fairly priced relative to what they might cost individually. In other cases, however, they represent only excessive charges for services never used. Unfortunately for the fiduciary, mere difficulty in parsing expenses does not relieve them of the duty to examine such costs and to assess their reasonableness. Be particularly skeptical of "black box" investment scenarios that trumpet wonderful results but fail to explain clearly how they work and what charges and costs apply.

17. *See* Knight v. Comm'r, 128 S. Ct. 782, 76 U.S.L.W. 4048 (U.S. Jan. 16, 2008).

18. The majority of structured settlements involve transfer of the obligation to make the future payments from the original obligor (defendant) to a third party. Such transactions are subject to IRC § 130, which limits the range of qualified funding vehicles to obligations of the U.S. government and annuity contracts from domestic life insurers.

19. This is a market limitation at present, not a legal or tax restriction. Further innovation may broaden these options.

20. Trusts cannot guarantee life-contingent payments because they are unable to spread the risk out over enough "measuring lives" to materially reduce the risk. Most trusts must manage and invest for the uncertain duration of a single life or relatively few lives, a highly unpredictable and thus risky endeavor.

21. In severe cases, the increase in benefits can reach 100 percent or higher.

22. Note the $4.1 million settlement in *Grillo v. Pettiette*, No. 96-145090-92 (96th Dist. Ct., Tarrant Cty., Tex. 2001), as reported in *Lawyers Weekly (VA)*, Aug. 2, 2001. *See also* Henry L. Strong, *Destructive Receipt: Hidden Ethics Risks Prompts Practice Adjustments*, 34 ADVOCATE 12 (Nov./Dec. 2006).

23. MODEL RULES OF PROF'L CONDUCT R. 1.4(b)(2002).

24. Matt L. Garretson, *Duty/Responsibilities of Lawyers in Connection with the Settlement of Cases* (Va. Trial Law. Ass'n, Mar. 31, 2005).

25. MODEL RULES OF PROF'L CONDUCT R. 2.1. cmt. [4] ("Matters that go beyond strictly legal questions may also be in the domain of another profession . . . 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.").

26. An excellent treatment of the Uniform Prudent Investor Act—indeed, of all modern prudent fiduciary investing—is found in *The Prudent Investor Act: A Guide to Understanding*, by W. Scott Simon (Camarillo, Calif.: Namborn Publishing, 2002).

27. *See* UNIF. PRUDENT INVESTOR ACT § 2(c) (1994).

© 2008 by the American Bar Association. Reproduced by permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.