Special Feature

THE REAL LESSONS OF *GRILLO*

Fiduciary duty in the new world of claim settlements

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News that a trial attorney and guardian *ad litem* paid $4.1 million to settle claims relating to a personal injury case that was settled on an all-cash basis made big waves in Texas in 2001.[1] Indeed, word of the case spread across the country rapidly, touching off a firestorm of debate that has not subsided regarding the scope of a trial attorney's duty to their client in the context of settlement.

Arguments over scope of duty may be intellectually stimulating but are of limited practical value in situations such as this. The better course is to examine the case, identify the specific nature and origin of the harms alleged, then determine how to eliminate them from your practice.

Part I

The most important lesson that trial attorneys should draw from the "Grillo" case is not to underestimate the economic value of IRC Section 104 income tax exclusion to their clients. This provision gives claimants the opportunity to establish a future stream of income completely free from federal or state income taxes, subject to certain conditions. Alternatively, most forms of investment income earned on the proceeds of a lump sum settlement are taxable as ordinary income on both the federal and state level, thus significantly reducing the claimant's net "spendable" income.

When calculated over a lifetime, the potential damages a client may suffer by paying an otherwise avoidable tax can quickly run into seven figures, as it did in "Grillo." The failure to harness this tax benefit at settlement can easily be compared to a failure to claim an element of damages in the suit itself, such as lost future wages or pain and suffering.

A structured settlement under IRC Section 104 represents a *substantial* economic value available to claimants in the resolution of their claim and attorneys who fail to consider this option leave themselves openly exposed to *Grillo*-type claims. Rather than debate *whether* trial counsel has a duty to alert a client to the benefits of a structured settlement, the safer response is to assume such a duty exists, analyze its implications, and adjust your practices accordingly.

Lesson #1: Don't ignore your client's opportunity for Section 104 tax exclusion.

Inform the client of the existence of this unique tax benefit, describe the basic advantages and disadvantages, make clear that you are not an expert in the field, then refer the client to a competent professional for further consultation and advice. Offer your firm's conference room as a meeting place and agree to either attend the meeting or have an associate sit in with your client and the structured settlement expert.

Lesson #2: If, after learning of their Section 104 tax benefits, your client still wants an all-cash settlement, have them sign a "Grillo Waiver" and retain that form in your file.

Since "Grillo" was not tried, we'll never know the extent to which the allegations were defensible. We do know that the trial attorney vigorously disputed the allegations, claiming that the Section 104 benefits had indeed been discussed, but that the client declined the offer.[2] If true, the real lesson of the case may not be a failure to consider the Section 104 benefits, but rather a failure to adequately document the file. Avoid this fate by securing your client's signature – *witnessed and dated* – on an appropriate "Grillo Waiver" form.

Lesson #3: If your client suffers from a potentially life-shortening medical condition or illness, be sure to explore price discounts available through "medical underwriting."

"Medical underwriting" is the process by which an annuity issuer reviews medical records of a claimant's physical condition to determine if a reduced life expectancy is warranted. (When annuity plans relate to life expectancy via "lifetime" payments, the duration of life expectancy becomes a major factor in pricing.) If the claimant's condition appears life shortening, issuers will reduce their prices accordingly.[3] Improvements over the standard price (for example, the cost of $1,000 per month for life) can be used to either increase future benefits or available cash at settlement.

This factor alone significantly increased the size of the "Grillo" damage claim: plaintiffs alleged that the extent of plaintiff's injuries would clearly have qualified for such a pricing discount, further increasing the "harm" suffered by the failure to structure the settlement.

Lesson #4: Consider anew the highest duty and standard of care to which you could be held and adjust your case management practices accordingly.

A trial attorney representing physically injured claimants may indeed *not* owe a duty beyond advocacy relating to the prosecution of the claim. Yet an absolute ruling on this may be hard to find (and dangerous to rely upon), as one's duties are shaped by case-specific facts and circumstances.

An attorney's duty to an unsophisticated client will inevitably be found to be higher than what is owed to a sophisticated client yet even sophisticated clients may credibly claim a lack of understanding. In either case, claims are only filed when the outcome turns bad – the money from a lump sum settlement is gone or seriously depleted. That very result would likely color a future determination of client competence: they exhausted the funds, ergo, they were unqualified to handle them. It is a simple task in hindsight to identify the "obvious" clues to a particular client's lack of sophistication that a responsible attorney "knew or should have known" about.

Part II

What is the potentially highest duty and most stringent standard of care to which a person might be held when making settlement decisions? In all probability: fiduciary duty and the prudent investor standard.

Such a duty may be explicit, as in the case of a guardian representing the interests of a minor, or implied due to some special circumstance (an attorney found to be *acting in the capacity of* a fiduciary). Either way, in the event one is found to owe fiduciary duties, the consequences of a breach of the related duty of prudence can be onerous indeed: high dollar damages easily calculated with few available defenses for the most common errors.

Anyone operating in a fiduciary capacity should fully acquaint themselves with the prudent investor standard. Conceptually more than 150 years old, this standard has served as the relevant standard applied to financial decisions made by one person on behalf of another for decades. Indeed, definitions of the standard appear in the trust statutes of virtually every state. A quick review of the Uniform Prudent Investor Act (UPIA)[4] provides an excellent overview of the relevant considerations. Although no statute yet exists tying this standard to structured settlements specifically, the prudent investor standard "can be expected to inform the duties" of other functionaries upholding similar responsibilities.[5]

It is beyond the scope of this paper to discuss all the elements of conduct that affirm a fiduciary's compliance with the standard. Instead, we focus on those elements that carry the largest financial implications to the claimant (and therefore the largest elements of damages in a breach action against the fiduciary) in the ordinary decision process of settling a personal injury claim. We focus specifically on those that relate to the consideration and implementation of Section 104 qualified structured settlements.

Potential Exposure #1: Failure to Consider the Effects of Taxation

The duty to consider the effects of taxation is an affirmative responsibility ascribed to prudent investors.[6] A fiduciary who selects an all-cash settlement on behalf of a physically injured claimant without considering the benefits of a Section 104 structured settlement risks running afoul of this standard, and it is a "one strike, you're out" offense: since one must avoid constructive receipt or economic benefit in the implementation of a qualified structured settlement, the act of receiving settlement funds in cash voids the opportunity to cure the harm.

Fiduciaries (and claimants) have one chance and one chance only to decide whether to implement a structured settlement that leverages the benefits of the Section 104 tax exclusion and that is before the settlement agreement has been drafted or any money has changed hands. The future payments must be expressly described in the settlement agreement and the claimant insulated from any incidence of benefit or control over the funds until the final terms are established and documents executed. This was the biggest element of damages alleged in "Grillo."

Potential Exposure #2: Failure to Consider the Claimant's Other Resources

Here we're talking specifically about recognizing a claimant's eligibility for public assistance programs – Medicaid, SSI, etc. — as an available settlement asset and factoring that into the settlement planning process. Listed specifically in the "Grillo" complaint[7], this too is a specialized area that requires the retention of outside experts. It may involve consideration of highly sophisticated devices such as the so-called "Special Needs Trusts" or "Medicare Set-Asides."

Potential Exposure #3: Failure to Consider Liquidity

Here the danger lies at the extreme ends of the spectrum: personal physical injury settlements involving total liquidity and zero liquidity may come under scrutiny in future years.

Total liquidity – an all-cash settlement – means waiving the aforementioned Section 104 structured settlement tax benefit. While it may indeed be unsuitable in some cases to commit *any* settlement funds to a tax-free structured settlement, the burden of defending such a decision will fall on the fiduciary. Greater liquidity also means increased dissipation risk: it is not always in a claimant's own best interest to have ready access to all settlement funds (think of a minor turning 18).

Equally difficult to defend may be settlements that are 100% structured with zero funds set aside for emergencies. Structured settlements are inherently illiquid: the injured plaintiff does not own the annuity nor can the payments be changed (these

are requirements that make the payments tax-free). Insufficient liquidity is no longer the absolute risk it once was, as new liquidity options are appearing in the marketplace even as this paper is written.[8]

Nevertheless, considering the liquidity needs of injured claimants is an *obligation* of a prudent fiduciary. It is generally wise to build liquidity into every settlement and avoid the extremes of all or none.

Key development

At about the same time that the "Grillo" complaint was being drafted, another important development took place in the structured settlement market that fundamentally alters the decision calculus used to craft settlements for claimants with long term income needs.

Summer of the year 2000 marked the arrival of the first fully Section 104-qualified equity-based structured settlement. Based on a reinterpretation of key language contained in IRC Section 130 (relating to the assignment of a defendant's future liabilities for structured settlement payments), it is now possible to tie a claimant's future payments, in part, to the performance of an investment portfolio such as an S&P 500 index fund equivalent, free from taxes on interest, dividends or capital gains.[9]

While the timing of the introduction of the equity-based structured settlement could not have been worse (arriving shortly after the beginning of a severe and sustained market downturn), the availability of this option prompts a major reexamination of standard and customary structured settlement design considerations. This is especially true for fiduciaries obliged to meet a prudent investor standard. The remaining potential exposures relate to this development.

Potential Exposure #4: Failure to consider the effects of inflation/deflation.

That we list failure to consider inflation here will surprise many a structured settlement veteran, as inflation is widely recognized as a concern for long-term claimants and many settlement plans attempt to address this very concern.

The problem stems from a fundamental misconception about the ability of fixed annuities to fight inflation. All fixed annuities are – just like the bond portfolios that back them – fixed income investments. Vulnerability to inflation is the Achilles heel of all fixed income investments. Although fixed annuity payments can be designed to increase over time, such periodic increases only change the *appearance* of the plan, not its actual value over time.

One need look no farther than the typical choice presented to most claimants: the question of whether to take a level payment plan or one whose payments increase by a fixed percentage every year. Although the annually increasing payments start lower, over time they pass the level monthly payment amount, ultimately delivering a higher total dollar payout.

Inflation-sensitive claimants typically choose the increasing annuity, believing it represents a greater value. But the truth is this: if both plans cost the same, then they are worth the same. The only way later payments can be increased is through reduction and deferral of the early payments. This is worth repeating: annually increasing fixed annuities only *defer* payments; they provide no increase in the real relative *value* of those payments. Paradoxically, in an inflationary environment, deferring funds could be the very worst economic decision to make.

How can this be? Simple: inflation does not affect the annuity payments themselves; *it affects the value of the currency in which they are paid*. Highly rated annuity issuers will likely make every scheduled payment in full and on time, yet those dollars may buy less. This is why inflation is often referred to as a "loss in purchasing power": you may have the dollars, you just can't purchase what you had planned to buy with them.

Those disturbed by this revelation may take solace in the fact that until the equity-based structured settlement option appeared, there was in fact no comparable funding option available: Section 130 of the tax code expressly forbids the use of anything but annuities and U.S. government obligations for use in assigned structured settlements. Anyone who wanted true inflation protection via long-term investment in stocks had to pursue that objective through prudent investment of the cash portion of their settlement (paying taxes along the way).

Although relatively rare and short-lived during the past century, fiduciaries must also consider the potential effects of deflation, a general trend of *decrease* in the prices of goods and services. If one expects a sustained period of deflation, then fixed income investments become more attractive, as the purchasing power of future dollars would be maintained or increased.

Fiduciaries must consider the effects of inflation and deflation in their decision-making. If they expect sustained deflation, then traditional fixed structured settlements are fine. However, if inflation is a risk, then ignoring the new qualified equity-based structures could be a costly mistake.[10]

Potential Exposure #5: Failure to diversify.

Diversification is such a critical element of the prudent investor standard that it occupies its own section in the UPIA[11]. Again, most attorneys and fiduciaries know the importance of diversification; they just may not recognize the need for it in this context.

The arrival of an equity-based structured settlement alters the diversification consideration. It is no longer legally sufficient to fund large long-term structured settlements with a single class of funding asset (fixed annuities); one must now diversify *between the classes* in some appropriate proportion.

Funding a structured settlement with fixed annuities only is like funding a pension trust fund exclusively with long-term bonds. Trust case law long

ago dealt with diversification errors like this one; such a decision is generally indefensible in court. Instead, one must diversify across asset classes, meaning a mixed allocation of cash, stocks and bonds (or more correctly in this case: cash, fixed rate structure and equity-based structure).

This is really no more than the classic "balanced portfolio" investment strategy applied to structured settlements: one allocates a certain percentage of assets to cash, a certain percentage to fixed income, and a certain percentage to equities to achieve the best balance of return relative to risk. (Bear in mind that over the long term, research has consistently shown that the addition of stocks to an all-bond portfolio has actually increased return while *reducing* risk.[12])

A truly "balanced" structured settlement like this offers another surprising benefit: a dollar-for-dollar reduction of default risk for the equity-based portion of the structure. Since fixed annuities involve a guaranteed rate of return, the plaintiff is relying on a guarantee from the annuity issuer. That guarantee is only as good as the credit quality of the annuity company, which is itself subject to change over time. Equity-based variable annuities do not involve such a guarantee. Rather than relying on a promise to pay, assets are held in custodial fashion, unavailable to creditors of the annuity issuer in the event of its insolvency.

Those who may feel uncomfortable with the idea of equity-based structured settlements might do well to remember that any bank trustee appointed to manage a large cash settlement on behalf of injured claimants is similarly *legally obligated* to diversify long-term portfolios in this very same fashion[13] – only when the bank does it, it's fully taxable. In the unique circumstances presented here, the fiduciary has the opportunity to build a portfolio that is not fully taxable.

Anyone with lingering doubts may wish to consider the words of David M. Cordell, Ph.D. in his recent article about equity-based structured settlements in the "Journal of Financial Planning": "Ignoring the variable annuity option is tantamount to violating fiduciary responsibilities and the prudent investor rule. Further, it is in direct contravention of established investment principals and Modern Portfolio Theory."[14] He goes on to conclude: "Odds are not good that, on an after-tax basis, most claimants would match the overall return of a balanced, non-taxable structured settlement allocated 50 percent to fixed income and 50% to equities."[15]

CONCLUSION

New developments in litigation and settlement options require constant vigilance. The attorney who chooses to ignore the threat of post-settlement claims and the advent of equity-based structured settlements does so at his or her own peril.

Endnotes

1. Josephine Grillo, As Guardian and As Next Friend for Christina Grillo, A Minor v. Tom L. Pettiette, T. E. Swate, and Hardy Milutin & Johns, 96th District Court, Tarrant County, TX, Cause No. 96-145090-92. Settlement amounts as reported in Lawyers Weekly 8/2/2001.
2. The attorney reportedly produced copies of settlement offer sheets allegedly bearing the guardian's signature. The guardian denied signing the documents, claiming forgery. (Lawyers Weekly 8/2/2001).
3. Reduced life expectancy means fewer payments and, therefore, lower cost.
4. Approved and recommended by the National Conference of Commissioners on Uniform State Laws 1994; Approved by the American Bar Association February, 1995.
5. UPIA Prefatory Note and Comments, April 18, 1995, page 3.
6. UPIA Section 2(c)(3).
7. "Nor was there any attempt to preserve Plaintiffs SSI and Medicaid eligibility." Grillo complaint, page 9.
8. Once the purview of unregulated "factoring" companies, it appears that annuity issuers have begun developing legitimate liquidity options for cases of true hardship. Subject to state and federal statutes, such liquidations generally require court approval.
9. Via a fully qualified variable annuity subaccount.
10. Utilization of equity-based funding vehicles necessarily introduces issues of performance volatility and claimant suitability. Retention of a qualified expert should be considered mandatory when contemplating this option.
11. UPIA Section 3.
12. "Research has demonstrated convincingly that a blend of fixed income investments plus equities offers superior return-risk combinations to a portfolio composed of fixed income investments alone." "Structured Settlements Meet Modern Portfolio Theory", David M. Cordell, Journal of Financial Planning, May, 2003.
13. Commercial Trust companies are subject to the trust statutes in their resident state.
14. See Cordell.
15. Id.

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APPENDIX — UNIFORM PRUDENT INVESTOR ACT

Drafted by the National Conference of Commissioners on Uniform State Laws (1994)
Approved by the American Bar Association and the American Banker's Association

SECTION 1. PRUDENT INVESTOR RULE.

(a) Except as otherwise provided in subsection (b), a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule set forth in this [Act].

(b) The prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust. A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust.

SECTION 2. STANDARD OF CARE; PORTFOLIO STRATEGY; RISK AND RETURN OBJECTIVES.

(a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.

(b) A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

(c) Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:
  (1) general economic conditions;
  (2) the possible effect of inflation or deflation;
  (3) the expected tax consequences of investment decisions or strategies;
  (4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;
  (5) the expected total return from income and the appreciation of capital;
  (6) other resources of the beneficiaries;
  (7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and
  (8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

(d) A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.

(e) A trustee may invest in any kind of property or type of investment consistent with the standards of this [Act].

(f) A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.

SECTION 3. DIVERSIFICATION. A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.

SECTION 4. DUTIES AT INCEPTION OF TRUSTEESHIP. Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of this [Act].

SECTION 5. LOYALTY. A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.

SECTION 6. IMPARTIALITY. If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.

SECTION 7. INVESTMENT COSTS. In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee.

SECTION 8. REVIEWING COMPLIANCE. Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight.

SECTION 9. DELEGATION OF INVESTMENT AND MANAGEMENT FUNCTIONS.

(a) A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in:
  (1) selecting an agent;
  (2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and
  (3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

(b) In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.

(c) A trustee who complies with the requirements of subsection (a) is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated.

(d) By accepting the delegation of a trust function from the trustee of a trust that is subject to the law of this State, an agent submits to the jurisdiction of the courts of this State.

SECTION 10. LANGUAGE INVOKING STANDARD OF [ACT]. The following terms or comparable language in the provisions of a trust, unless otherwise limited or modified, authorizes any investment or strategy permitted under this [Act]: "investments permissible by law for investment of trust funds," "legal investments," "authorized investments," "using the judgment and care under the circumstances then prevailing that persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital," "prudent man rule," "prudent trustee rule," "prudent person rule," and "prudent investor rule."

SECTION 11. APPLICATION TO EXISTING TRUSTS. This [Act] applies to trusts existing on and created after its effective date. As applied to trusts existing on its effective date, this [Act] governs only decisions or actions occurring after that date.

SECTION 12. UNIFORMITY OF APPLICATION AND CONSTRUCTION. This [Act] shall be applied and construed to effectuate its general purpose to make uniform the law with respect to the subject of this [Act] among the States enacting it.

SECTION 13. SHORT TITLE. This [Act] may be cited as the "[Name of Enacting State] Uniform Prudent Investor Act."

SECTION 14. SEVERABILITY. If any provision of this [Act] or its application to any person or circumstance is held invalid, the invalidity does not affect other provisions or applications of this [Act] which can be given effect without the invalid provision or application, and to this end the provisions of this [Act] are severable.

SECTION 15. EFFECTIVE DATE. This [Act] takes effect .....

SECTION 16. REPEALS. The following acts and parts of acts are repealed:

Adopted by the following states as of 5/1/03 as per NCCUSL website:

Alaska	Arizona	Arkansas	California
Colorado	Connecticut	D.C.	Hawaii
Idaho	Illinois	Indiana	Iowa
Kansas	Maine	Massachusetts	Maryland**
Michigan	Minnesota	Missouri	Montana
Nebraska	New Hampshire	New Jersey	New Mexico
North Carolina	North Dakota	Oklahoma	Oregon
Pennsylvania	Rhode Island	South Carolina	Tennessee
Utah	Vermont	Virginia	Washington
West Virginia	Wyoming		

***Substantially Similar*