Good Use of Structured Settlements in Bad-Faith Claims

Financial tool can be used in personal injury and commercial tort cases

By JOHN DARER

Structured settlements may be a useful tool to help attorneys and their clients resolve bad-faith insurance claims. Solutions are available for both tax-excludable damages and taxable damages. Regardless of your plaintiff or defense orientation on a particular case, it is well worth becoming knowledgeable about your client's structured settlement options when working with a bad-faith claim.

Structured settlements are most widely known, and commonly used, to provide periodic payments as a component of consideration for a release in cases where there are damages for personal physical injury, physical sickness, wrongful death or workers' compensation. These are known as qualified structured settlements (or tax-qualified structured settlements) because the transactions involve a "qualified assignment" within the meaning of the Internal Revenue Code §130. Nonqualified structured settlements are used when the damages the structured settlement payments represent are taxable.

Origin of Claim Doctrine

In general, the character of the amount received as proceeds from a lawsuit or a settlement depends on the nature of the claims and the actual basis for the recovery. Under the "origin of the claim" doctrine, it is a "well-settled rule" that the classification of amounts received in settlement of litigation is to be determined "by the nature and basis of the action settled," and that "amounts received in compromise of a claim must be considered as having the same nature as the rights compromised" (IRS Private Letter Ruling 200903073, citing *Alexander v. IRS*, 72 F.3d 938 (1st Cir. 1995)).

Personal Physical Injuries

IRS Private Letter Ruling 200903073 involved an insurance bad-faith claim that, but for the assignment to the injured plaintiff (a highway construction worker struck by a drunk driver), would have been owned by the defendant tavern that was the insured policyholder. Yet the claim was pursued by an injured plaintiff, and he recovered compensation "on account of" his physical injuries that left him a quadriplegic. The ruling applied the IRC §104 exclusion that exempts such recoveries from income, with the exception of punitive damages (which are always a taxable).

It may have been the assigned insurance bad-faith claim that enabled the plaintiff to sue the tavern's insurance company, but it was the nature of the underlying injury and the plaintiff's claim against the tavern and the tavern manager that sparked the insurance-claim assignment that ultimately led to the monetary recovery. The focus on the taxpayer and why he is receiving the amount plainly satisfies the "on account of" claim nexus.

The IRC §104 exclusion is critical to using traditional qualified structured settlements in bad-faith cases. An IRC §130 qualified assignment cannot happen if there is no IRC §104 exclusion.

Nonphysical Injuries

The focus is on the taxpayer and why he or she is receiving the compensation. If the claim under the bad-faith assignment involves punitive damages, nonphysical injuries or commercial torts, or otherwise does not constitute recovered compensation "on account of" his or her physical injuries, damages are taxable and a nonqualified structured settlement solution is an appropriate choice. Nonqualified structured settlements are a tax-deferral vehicle for taxable damage cases, offering similar flexible design as qualified structured settlements with a few different wrinkles. Nonqualified structured settlements might also be used where there is an allocation between "on account of physical injury" damages and not "on account of" damages.


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Nonqualified structured settlements come in several forms: (1) a nonqualified assignment with the periodic payment obligation funded with a structured settlement annuity issued by a regulated life insurance company; (2) a nonqualified assignment funded with U.S. Treasury obligations held in a trust, administered by an institutional trustee, created for the exclusive purpose of entering into nonqualified assignments; (3) third-party periodic payment reinsurance; and (4) nonqualified assignment with more esoteric funding instruments.

Nonqualified assignment companies are typically found offshore, with Barbados a favored locale, not so much for its sandy beaches, but for its long-standing favorable tax treaty with the United States. With few exceptions, annuities owned by "nonnatural persons" in the United States are taxed less favorably to the owner and the design is not as flexible. For example, payments must begin within a year and payments must be substantially equal and made no less frequently than annually (see IRC §72(u)). Liberty Life Assurance Co. of Boston, a regulated insurance company licensed to do business in all 50 states, has been writing annuities that fund nonqualified structured settlements in conjunction with Barbados-based Barco Assignments Ltd. for almost 20 years. Liberty Life is a shareholder in Barco and provides a financial commitment to Barco for each of its nonqualified assignment obligations. Liberty Mutual Insurance Co., a prominent workers' compensation insurer, offers additional security through a guarantee of Liberty Life's payment obligations.

A Treasury-funded nonqualified structured settlement uses another Barbados assignment company, Structured Assignments Inc. In contrast to the annuity-funded, nonqualified structured settlement described in this article, the future periodic payment

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obligations of Structured Assignments are backed by obligations of the U.S. government that are held in trust at Midwest Trust Co., a Kansas-based company with more than $15 billion in assets.

With each nonqualified assignment to Structured Assignments, Midwest Trust issues a keep-well agreement in which Midwest Trust agrees to ensure the Treasury obligations held inside Structured Assignments are maintained to fund and satisfy the periodic payment obligations.

Periodic payment reinsurance through Berkshire Hathaway's U.S.-domiciled National Indemnity Co. is another potential option for nonqualified structured settlements. Another major U.S.-domiciled insurer recently introduced a nonqualified structured settlement alternative. However, the scope of the obligations it will take on is narrow. It is expected that the insurer will enlarge the scope in due course, but it's not currently a viable option for bad-faith settlements. ■

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