# Understanding NONPHYSICAL INJURY Structured Settlements

## Why This Underused Claims Resolution Technique Deserves a Fresh Look

By Dan Finn

When civil jurors get angry enough, they exercise the only power available to them when tasked with the responsibility of choosing how best to right a perceived wrong: They award dollars. Lots and lots of dollars. And if several high profile celebrity court cases are any indication, they have really had it with dishonorable, salacious tortfeasors invading someone else's privacy.

In *Erin Andrews v. Nashville Marriott et al.*, a Tennessee jury decided the unconscionable actions of an admitted stalker and the complicit negligence of the enabling hotel staff sufficiently violated the complainant's right to privacy and caused her undue emotional distress among other damages. They awarded Andrews $55 million.

Not to be outdone, the *Hulk Hogan v. Gawker* jurors in Florida doubled down by awarding $115 million in damages for invasion of the pro wrestler's privacy, then went even further by tacking on $25.1 million in punitive damages against the tabloid media outlet just for good measure.

When public interest in cases like these fades—as it always does—the litigants, their attorneys, and any insurance carriers providing coverage begin the standard post-verdict evaluation process of deciding how best to proceed. Appeals, almost always initiated when either side considers the outcome of a trial irrational, are instinctive options in these types of cases and countless others that occur regularly each year but with far less public fanfare. Andrews has subsequently compromised her lawsuit (the terms of which remain confidential), while Gawker's planned appeal decision is still pending.

Because appeals can be so costly and carry additional risks for both plaintiff and defense, parties routinely seek compromise solutions through post-verdict negotiation in an effort to end the litigation and avoid an even more uncertain outcome.

Surprisingly, even some of the most seasoned negotiators, attorneys, and mediators completely overlook one of the most potent tools available to them during this process: nonphysical injury structured settlements.

### Qualified Assignment Limitations Creates Need

Traditional structured settlements for physical injury claims have enjoyed widespread popularity since their formal creation more than 30 years ago. Made possible by 26 USC § 104(a)(2), structured settlements facilitate successful claims outcomes because of their unique ability to match future dollars with future needs by providing injured parties with predictable, guaranteed, tax-free income tailored to their anticipated future situations. This matching of future dollars to future needs also benefits claims professionals, who then can evaluate loss exposures more accurately and manage claims costs.

As early as the Revenue Act of 1918, Congress advanced the notion that certain

income should be exempt from taxation including "…(a)mounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received…on account of such injuries or sickness." The passage of the Periodic Payment Settlement Act of 1982 (H.R. 5470) merely extended this long-standing tax position to settlement payments made over time, provided that certain procedures are followed to avoid running afoul of other tax doctrines (constructive receipt chief among them).

Most insurance carriers adopting structured settlement programs are familiar with the 26 USC § 130 qualified assignment process—simultaneously created by Congress in 1982 to facilitate § 104(a)(2) settlements—which permits settling defendants and/or their carriers to resolve claims using periodic payments, yet still take down their reserves for the claim in the year settlement is achieved and fully funded. Absent the qualified assignment, carriers entering into periodic payment agreements would have to retain any contingent future obligation, which would keep it on their books until the last payment is made. Combined, § 104(a)(2) and § 130 make structured settlement efficiency possible.

In order for qualified assignments to work properly, they must follow a few basic steps. Keep in mind that this solution is only viable when physical injury claims are being settled:

1. Adverse parties agree to a settlement, which includes a defense obligation to make future periodic payments to the plaintiff.
2. Defendant (assignor) then assigns its obligation to a third party, special purpose legal entity (assignee) via a qualified assignment and sends funds sufficient to secure said payments from (usually) a previously selected life insurance company. (Note: U.S. Treasury obligations also are used, though less frequently).
3. Assignee accepts the assignment and purchases an annuity contract directing payments to the plaintiff as agreed.
4. All parties execute the appropriate release and qualified assignment documents, and contracts are issued. In order for the plaintiff to avoid constructive receipt, the assignee retains ownership of the contract, though the plaintiff owns all rights to the future periodic payments. Everyone agrees to this arrangement.

Because current structured settlement statutes apply only to verdicts and settlements when a plaintiff claims personal physical injuries or illness, many types of claims falling outside the scope of the laws as written cannot be negotiated using the traditional qualified assignment process. Nonphysical injury claims, such as invasion of privacy, wrongful termination, breach of contract, false arrest, slander, harassment, and countless others, require a different approach.

Fortunately, the industry recognized this limitation of qualified assignments and designed a nearly identical and aptly named "nonqualified assignment process" to aid in the resolution of the many nonphysical injury claims occurring each year. From the perspective of the defendant or the insurer providing coverage, the mechanics of this offshoot process developed about 20 years ago are, for all intents and purposes, exactly the same.

At first blush, any advantage of utilizing this nonqualified assignment approach appears to go to the exclusive benefit of the plaintiff. However, when defendants and their carriers incorporate nonphysical injury structured settlements into their regular settlement strategies and post-verdict analyses, the advantages to both sides in a civil dispute become more obvious. By taking time to compare and contrast the net effect of a large, taxable, lump-sum verdict or settlement to taxable payments made over time from the plaintiff's perspective, defendants will find the door to a more productive negotiation dialog opening wide.

### The Taxable Damages Factor

Because an inadvertent loophole remained in the 1982 version of the act that broadly addressed claims disputing "personal injuries" or sickness, practitioners and participants routinely sought to qualify all sorts of damages for the income tax-free preferential treatment accorded under § 104(a)(2), even if the injuries sustained didn't appear to align with the initial spirit of the law (personal injuries that were physical in nature). Most of the ambiguity was eliminated when Congress later passed the Small Business Job Protection Act of 1996, which added the word "physical" to the code. The law, in its current state, makes abundantly clear that gross income does not include: "…the amount of any

damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal **physical** injuries or **physical** sickness…." (Emphasis added.)

The addition of the word "physical" to the code effectively ensured that many types of claims whose origins were not physical in nature would be fully taxable when paid—either as a lump sum or as periodic payments—even if the tort contained allegations of emotional distress that can manifest physical symptoms.

Speaking of emotional distress, the framers took special care in § 1605(b) to put taxpayers on notice that "… emotional distress shall not be treated as a physical injury or physical sickness," except to the extent that actual medical expenses are incurred. The somewhat subjective and challenging-to-measure nature of emotional distress made this particular type of injury an easy target for a legislative assembly seeking to clarify the law. Especially when, in responding to conflicting court opinions, they were simultaneously modifying the law in § 1605(a) to expressly preclude punitive damages from § 104(a)(2) consideration.

Unfortunately for Andrews and Hogan, the law is clear. Since no physical contact occurred between any of the defendants and their accusers, presumably no portion of any settlement or verdict proceeds ultimately paid (except potentially certain medical expenses not previously deducted) qualify as tax exempt under § 104(a)(2). Thus, they will owe taxes on their recoveries. This nuanced point is widely misunderstood and may even come as a surprise to the celebrity litigants and their counsel since emotional distress damages occurring as a result of a physical injury claim qualify for the more favorable § 104(a)(2) tax treatment. This may strike some as inconsistent, but the law is unambiguous: the origin of the claim matters.

## Smaller Settlement, Increased Recovery

Borrowing from the popular investment philosophy "It's not about what you make, it's what you keep," and adapting it to taxable damage settlements and post-verdict discussions, plaintiffs ultimately will care more about their net recoveries than they will any gross dollar figure. Because of the progressive nature of our nation's income tax system, large, taxable, cash lump-sum awards can fail to compensate the plaintiffs as the jurors intended and disproportionately tax them all at once even when the damages are intended to compensate them over time.

This creates a rare opportunity for the defense and plaintiff to engage in a positive dialog that may result in a settlement value that both sides can agree to but one that nets the plaintiff more money than a lump-sum cash award could—even if the compromise figure is smaller.

While tax evasion is illegal, the Internal Revenue Service's own website assures taxpayers that "tax avoidance is perfectly legal and encouraged by the IRS," and citizens have been using accepted tax deferral strategies with good result since the inception of the tax code itself. The U.S. Department of Labor lists more than 88 million participants in one widely encouraged tax deferral strategy: defined contribution retirement plans, such as 401(k)s. Parties naturally are cautioned to avoid giving tax advice unless qualified to do so, but understanding how taxes impact any final decisions can lead to better outcomes for all, especially since some lawsuits may involve capital gains considerations.

As one's taxable income increases during any given taxable year, each dollar is taxed according to tax brackets established by federal, state, and local taxing authorities. While an individual may only pay 10 percent federal tax on any earned income up to $9,275, that same individual pays a 39.6 percent tax on every dollar earned over $415,050. This tax burden is magnified in high income-tax states like California, where the top combined marginal rates can exceed well over 50 percent for exceptionally high wage earners.

Generally speaking, to the extent that any taxpayer can postpone receipt of a highly taxed dollar into the future when it may be taxed at a lower rate, they save money. This savings benefit always must be weighed against the time value of money. However, deferring the income will be beneficial only if a more suitable use for the present year, after-tax sum cannot be found.

Because nonphysical injury structured settlements also earn pretax interest when spread out over a sufficient number of years, plaintiffs also derive the added benefit of earning interest on sums that they would otherwise pay in taxes the first year if they settled for cash. For the same reason many individuals participate in a 401(k) and other similarly defined contribution retirement plans, many plaintiffs will appreciate the benefit and flexibility of nonphysical injury structured settlements.

Even when the recipients are presumed to be in a perpetual high tax bracket, the benefit of spreading the settlement or award out over a number of years still can be quite valuable. It would be a mistake to assume that any plaintiff would dismiss nonphysical injury structured settlement overtures because they are "already well off." Since the cash flows from the nonphysical injury structured settlement pay sums with tax-advantaged yields that can be significantly higher than other available options of similar risk, most financially astute plaintiffs will be open to the conversation.

## Less Can Be More

Nonphysical injury structured settlements using a nonqualified assignment process hold great promise for successfully concluding nonphysical, injury-based claims. Thorough analysis of the potential impact that taxes can have on any nonphysical injury settlement or verdict can lead to better outcomes for all settling parties. By spreading taxable compensation dollars over a number of years instead of paying all at once, a plaintiff can earn interest on pretax income and potentially pay income taxes at an overall lower rate. Defendants and insurance carriers engaging in settlement discussions using this method often can conclude claims for sums otherwise unacceptable to the plaintiff, since the after-tax benefit of periodic payments may serve as an incentive to settle. In these instances, Robert Browning's line "Less is more," comes to mind as an especially fitting mantra for claims professionals evaluating these types of losses and seeking effective, tax-advantaged solutions. CM

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