The Advantages of Qualified Settlement Funds

Pi-Yi Mayo*
and
Bryn Poland
5223 Garth Road
Baytown, Texas 77521

*Certified Elder Law Attorney by the National Elder Law Foundation

Nothing in this paper is to be construed as the rendering of legal advice for specific cases, and readers are responsible for obtaining such advice from their own legal counsel. This publication is intended for educational and informational purposes only.

TABLE OF CONTENTS

THE ADVANTAGES OF QUALIFIED SETTLEMENT FUNDS

I. INTRODUCTION

You have been diligently preparing for an important upcoming trial. The trial date has been set; you are deep in trial preparation. You are in the middle of heated negotiations with the defense. Suddenly, the defense makes a settlement offer that pleases your client. The offer, however, is conditioned upon wrapping-up the defendant's involvement in a timely matter. Now you are pressed for time and you must quickly finalize any subrogation claims, possible structured settlement options, Medicare Set-Aside needs, possible allocation issues, and any special needs trust issues. If only there was a way to accept the defendant's offer, cut the defendant loose, and finalize the remaining issues later.

Section 468B of the Internal Revenue Code allows defendants to make payments to a court-created trust fund. The payments must be wired into a bank account that is subject to the court's continued oversight. The payments to the fund made by the defendants are tax-deductible and the defendants are released from liability while the remaining issues are resolved.

II. DEFINITION OF 468B SETTLEMENT FUND

Generally speaking, 468B funds act as an intermediary party to a lawsuit. These funds allow defendants and their insurers to make payments to a court-created trust fund. The fund is subject to the court's continued oversight. The payments to the fund made by the defendants are tax-deductible to the defendants at the time payment is made, no matter when the plaintiff actually receives payment from the fund. In addition, the defendants are released from liability at the time they make the payments to the fund. The fund administrator then works to make proper allocations among plaintiffs and claims. The administrator has the flexibility to arrange payments in a number of ways including cash payments, periodic payments, or through a special needs trust.

These 468B funds get their name from the Internal Revenue Code section under which they are created. In the 1980s, congress passed Section 468B of the Internal Revenue Code, thereby creating Designated Settlement Funds.[1] These funds were limited in the way they could be used. In 1994, however, the Treasury Department added regulations under Section 468B that expanded the use of these funds and created a new type of fund entitled “Qualified Settlement Funds.” The added regulations expanded the range of claims in which the funds can be used, and now these funds are available in personal injury, breach-of-contract, and environmental claims. These 468B funds are not available for liabilities under the worker's compensation act, however.

To establish a valid QSF, there are three requirements. First, it must be established or approved by governmental authority and must be subject to the continuing jurisdiction of that authority.[2] This requirement is met when the government authority issues a preliminary order to establish the fund. An order from the court approving the fund, or even an award granted by an arbitration panel is sufficient to meet this standard so long as the award is judicially enforceable and the fund is subject to the panel's continued jurisdiction.

Secondly, the fund must be established to resolve contested or uncontested claims asserting liability for a tort, breach of contract, or violation of law.[3] This requirement has been interpreted strictly by the courts. A QSF cannot be used to provide restitution. It is only available in those cases in which the fund can be used to satisfy a requisite claim.

Finally, the fund must meet the requirements of a trust under applicable state law. Alternatively, the monies placed in the fund must be kept separate and apart from the assets of the defendant, the defendant's insurance carrier, or other related parties.[4]

III. STRUCTURED SETTLEMENTS AND QSFs

There are some significant tax advantages to using a QSF. Of course, damages received by a plaintiff for personal injuries or sickness are excluded from the plaintiff's taxable income.[5] These damage awards are given preferable tax treatment regardless of how the plaintiff chooses to receive payment–lump sum payments are treated the same as a series of periodic payments. This income exclusion is not affected by the manner is which payments are structured. The tax free treatment is available even though each periodic payment represents part of a return of principal and part income earned from the investment of that principal.

The tax-free treatment is lost, however, at the time the plaintiff constructively or actually receives the funds.[6] At that point, any income earned from investing the funds is subject to taxation. Thus, it is critical to avoid constructive receipt of any future structured payments until those payments are paid out. So long as the funds are subject to substantial limitation, constructive receipt is avoided and the plaintiff can take full advantage of the tax-free status of such payments.[7]

Avoiding constructive receipt can often cause difficulties for plaintiffs during the process of settlement. For example, where a couple has a medical malpractice claim against a doctor and a hospital for injuries occurring during a standard procedure, the doctor may agree to settle the case for the policy limits on his malpractice insurance policy but the hospital continues to contest liability. The plaintiffs want to consider structuring all or part of the settlement but they are unsure as to how much to structure because they are still uncertain as to what the total settlement will be.

By establishing a QSF for the plaintiffs, the plaintiffs have much more flexibility. Paying settlement funds from the individual doctor into a QSF until all the claims have been settled allows the plaintiffs a better picture of the entire settlement amount. The doctor can deposit the settlement amount into the QSF and he receives a full and complete release. That portion of the settlement remains in the QSF until all the claims are settled–all the while, earing interest for the plaintiffs. The plaintiffs do not have constructive receipt so long as there are sufficient issues still in dispute, such as the allocation issues between husband and wife, to constitute a substantial limitation. There are many other advantages to establishing a QSF, which are discussed below.

IV. ADVANTAGES OF USING A QSF

Using a QSF in a personal injury case has many advantages. Both plaintiffs and defendants can benefit from the use of a QSF. In addition, there are numerous advantages for the attorneys representing plaintiffs. The use of a QSF can give the plaintiffs time to resolve any remaining issues. The defendants have the advantage of walking away while those issues are resolved. Plaintiff's attorneys have the benefit of a professional QSF administrator to handle issues such as special needs trusts, Medicare set-aside trusts, and any Medicare or Medicaid liens.

A. Advantages to Defendants

Although QSFs provide many advantages to plaintiffs and plaintiffs' counsel, Qualified Settlement Funds are not without advantages to defendants. Establishing a QSF allows a defendant to disengage from litigation. After a QSF is created, the plaintiffs execute a release of liability and economic performance takes place immediately upon payment into the fund. Defendants can walk away without being bothered by allocation issues or waiting on the Medicare or Medicaid liens to be settled. For this reason, defendants often agree to the establishment of a Qualified Settlement Fund.

B. Advantages to Plaintiffs

Using a QSF has great advantages to a plaintiff and to plaintiff's counsel. The first advantage is breathing space. Many times, settlements occur so quickly that there is not enough time to truly evaluate the advantages and disadvantages of alternative forms of distribution, such as structured settlements. Using a QSF allows for the settlement to move forward while preserving all distribution options for each claimant. This allows each claimant time to decide on the form of distribution that best suits his or her needs.

In some instances, using a QSF also allows for easier apportionment of shares.

Often times, individuals within a group of claimants cannot agree on how to apportion the proceeds of a settlement among themselves. Using a QSF may help solve that problem because the Fund Administrator is able to negotiate with individual claimants or their counsel to resolve these issues.

Establishing a QSF also helps eliminate the risk of insolvency by the defendant or its insurer. If the plaintiff is aware that the defendant's financial status is unstable, establishing a QSF allows for quick transfer of funds to protect the plaintiff's interest while the remaining issues are being settled. This can be a great protection for the plaintiff in any case where the defendant's financial situation is unstable.

The last, and possibly greatest, advantage to a plaintiff is that the plaintiff earns all the interest on the funds while the money is in the QSF. Rather than the defendant earning interest on the funds while allocation and other issues are being resolved, the defendant places the funds into a QSF while those issues are resolved. The plaintiff receives all interest earned while the money remains in the fund. In the case of a settlement for millions of dollars, daily interest payments can mean thousands of dollars in additional money in the plaintiff's pocket.

C. Advantages to Plaintiff's Counsel

Subject to the approval of the court, a QSF may pay attorney's fees as soon as proceeds have been delivered to the QSF. This can mean that plaintiff's counsel is able to receive payment prior to the resolution of many issues. Plaintiff's counsel also has the advantage of time. Just as claimants need some breathing room after making the decision to settle and before deciding upon the form of distribution, so does plaintiff's counsel. This space allows attorneys to evaluate and make recommendations as to the form of distribution. The attorney may decide to structure his or her fees, obtain tax deferral, or take a lump-sum cash payment.

A QSF can also help plaintiff's counsel to resolve issues between claimants. In any case with multiple claimants whose interests are adverse, an attorney may find himself or herself unable to resolve apportionment issues. This is often the case when a claim involves a minor child and parents who are divorced. The QSF fund administrator can act as an independent person who negotiates apportionment of shares. The Administrator fills this role as a fiduciary and is subject to the court's oversight.

Just as a QSF Administrator can assist in allocation issues, the Administrator can offer much more to plaintiff's counsel. Few attorneys have the necessary knowledge, skills, or resources to help clients with special needs trusts or Medicare set-aside trusts.

These trusts, however, are necessary in many cases to preserve eligibility for government benefit programs. A fund administrator should have professional experience in the area of special needs trusts and Medicare set-asides and should be able to address these issues for the plaintiff's counsel. The fund administrator can also oversee any Medicare or Medicaid lien resolutions that are necessary.

V. CHOOSING A FUND ADMINISTRATOR

Professional administrators specialize in establishing and managing Qualified Settlement Funds. Because the fund administrator has a fiduciary duty to the plaintiffs, it is important to be sure and chose someone who has experience and expertise in this area. The administrator will draw up the documents to establish the fund, he or she will handle funding any trusts or structured settlements, and file any tax returns. The role of Fund Administrator is an important and complex one. The selection of a qualified person should not be without consideration. The best way to minimize the risks associated with using a QSF is to choose a skilled and reliable administrator.

Some structured settlement brokers market themselves as fund administrators as a method of capturing more brokering business. They may not, however, understand the seriousness of the administrator's role or have the requisite knowledge to handle special needs trusts, Medicare set-aside trusts, or Medicaid eligibility. All of these issues may be involved in a QSF. It is important to select an administrator who has experience in handling these issues.

Selecting a professional administrator allows the plaintiff's attorney to focus on settling the case. The administrator will handle the mechanics of the QSF leaving the plaintiff's attorney free to handle any remaining issues surrounding settlement. By choosing the right administrator, the attorneys involved can be sure all the issues will be handled accurately.

VI. CONCLUSION

Using a Qualified Settlement Fund can simplify settlement. The risk and complexity of establishing a QSF is minimal and these funds can provide plaintiffs with the luxury of time. Attorneys fees and costs can be quickly paid from a QSF. The defendants are released and then excluded from further involvement in finalizing settlement issues. The Qualified Settlement Fund is an important tool that every trial attorney should consider using.

N:\Pi-Yi Files on the server\SPEECHES\State Bar Damages feb-19-09 Dallas\QSF

DRAFT 2.wpd

1. The Code Section 468B(d)(2) sets forth the following requirements for a “designated Settlement fund”:

> “The Term designated settlement fund means any fund-
> (A) which is established pursuant to a court order and which extinguishes completely the taxpayer's tort liability with respect to claims described in subparagraph (D),
> (B) with respect to which no amounts may be transferred other than in the form of qualified payments,
> (C) which is administered by persons a majority of whom are independent of the taxpayer,
> (D) which is established for the principal purpose of resolving and satisfying present and future claims against the taxpayer (or any related person or formerly related person) arising out of personal injury, death, or property damage,
> (E) under the terms of which the taxpayer (0r any related person) may not hold any beneficial interest in the income or corpus of the fund, and
> (F) with respect to which an election is made under this section by the taxpayer.

2. Tres. Reg. § 1.468B-1(c).

3. *Id.*

4. *Id.*

5. I.R.C. § 104(a)(2).

6. I.R.C. § 451.

7. Treas. Reg. § 1.451-2.