

STRUCTURED SETTLEMENT PROTECTION ACT

House Bill 5066 (Substitute H-2) First Analysis (3-14-00)

Sponsor: Rep. Andrew Richner
Committee: Family and Civil Law

THE APPARENT PROBLEM:

“Structured settlement” is a term used to describe the settlement of a tort claim by way of a series of future installment payments. Generally, under a structured settlement the beneficiary or claimant is paid over a period of years in a series of installments with set payment terms in lieu of a lump-sum payment. The payment of lump sums used to be the standard form of payment for personal injury cases. Unfortunately, many injured persons who received such lump-sum payments were unable to manage the money in a way that would cover the injured party’s ongoing medical and living expenses. Indeed, all too often, the lump sum that usually was intended to pay for a lifetime of expenses would be spent in a matter of months or years. If the injured person had been disabled and was unable to work, he or she would be left to rely upon public assistance.

Structured settlements gained popularity in the late 1970s as a means of ensuring that an injured party did not dissipate a lump-sum award. Further, the use of a structured settlement provided the party that agreed to pay with a better deal as well. Since a payment of a million dollars over a period of years costs less than making that payment as a lump-sum next week, those making the payments found it advantageous to reduce their out-of-pocket costs while still providing the injured party with the funds to meet his or her needs resulting from the injury. In an effort to increase the use of structured settlements, the federal government has enacted special rules regarding the tax status of the payments, both with regard to the injured parties and the parties making the payments. [For further explanation of the tax treatment of structured settlements see the *Background Information*.]

Over the past two years, there has been a dramatic increase in what are known as “factoring” transactions. The practice of factoring involves the sale of the right to continued payments under a structured settlement for a lump sum. The injured party is paid a lump sum, in

an amount discounted from the present value of the structured settlement payments. The business of buying the rights for such payments has grown rapidly, and many feel that the unregulated sale of structured settlement payments undermines the basic purpose of those settlements.

THE CONTENT OF THE BILL:

The bill would create the Structured Settlement Protection Act to establish conditions for the transfer of rights to payments made under a structured settlement. A structured settlement would be defined as an arrangement for periodic payment of damages for personal injuries established by settlement or judgment in resolution of a tort claim or for periodic payments in settlement of a workers’ compensation claim.

The bill would prohibit the transfer of an individual’s right to receive a structured settlement payment if the structured settlement agreement contained a contractual assignment restriction (a term that prohibits or restricts the transfer of a structured settlement payments right in a contract or agreement), unless the transfer met certain conditions. The bill would apply to structured settlement payment rights where the payee or a protected party was a Michigan resident or the settled claim was pending before a Michigan court when it was settled, or stemmed from a worker’s compensation claim under Michigan’s Worker’s Disability Compensation Act. The conditions would include approval of a court in advance in a final order and the provision, in writing, of certain consents and waivers from each protected party.

Applicability. The act would apply to only to those transfers of a right to receive structured settlement payments under a transfer agreement that was reached on or after the thirty-first day after the act took effect. The act would not affect the enforceability or effectiveness of any transfer agreements that were

reached before the act's effective date, nor would it affect the enforceability of any obligation to make a payment to a transferee under an agreement that was reached before the act took effect. Further, the act would specify that it was not to be construed as authorizing any transfer of a structured settlement payment right that was in contravention of applicable law or as giving effect to any transfer of a structured settlement payment right that would be void under applicable law. (Applicable laws would include federal law, the laws and principles of equity of this state, and the laws of any of the following: the domicile of the payee, a jurisdiction where a settled claim was pending before a court when the structured settlement was reached, or a jurisdiction where a settled claim for worker's compensation was brought under the jurisdiction's worker's compensation statute.)

Court Approval. The circuit court would have jurisdiction over an application for approval of a transfer of structured settlement payment rights under the act. In addition to finding that the transfer met the requirements of the act and would not violate any other applicable laws, the court also would have to determine that the transfer was needed to enable the payee or the payee's dependents, or both, to avoid imminent financial hardship and that the transfer was not expected to subject the payee and/or his or her dependents to undue financial hardship in the future. Further, the court could not approve a transfer unless the payee had received independent professional advice regarding the financial and legal effects and consequences of the proposed transfer, and unless the discount rate used in determining the discounted present value of the structured settlement payments to be transferred did not exceed 25 percent per year. [The bill would define "discounted present value" to mean the fair value of future payments as determined by discounting the payments to the present using the most recently published applicable federal rate for determining the present value on an annuity issued by the federal Internal Revenue Service.] The court would also have to determine that written notice of the transferee's name, address, and taxpayer identification number had been provided to the annuity issuer and the structured settlement obligor and that a copy of that information had been filed with the court.

In addition, the court would have to determine that the transferee had provided the payee and each of his or her dependents who were party to the agreement with a disclosure statement. That disclosure statement would have to be supplied to the payee and each of his or her dependents no less than ten days before the date

that the payee entered into the transfer agreement. The disclosure statement would have to be in boldfaced type no smaller than 14-point and include all of the following information:

- The amounts and due dates of the structured settlement payments that would be transferred and the aggregate amount of the payments that would be transferred.
- The discounted present value of the structured settlement payments that would be transferred and the discount rate or rates used to determine that value.
- The gross amount that would be paid to the payee in exchange for transfer of the structured settlement payments and an itemized listing of any commissions, fees, costs, expenses, and charges that the payee would be responsible for or would be paid out of the gross amount payable to the payee and the resultant net amount to be paid to the payee. The statement would also have explain, as a percentage, net payment divided by the discounted present value.
- The amount of any penalty and the aggregate amount of any liquidated damages and penalties that the payee would be required to pay in the event that the payee was in breach of the transfer agreement.

No less than 21 days before a hearing on such an application, the person to whom the payments would be transferred (the transferee) would be required to file with the court and serve each of the protected parties with all of the following: a) notice of the proposed transfer and application for court approval, b) a copy of the transferee's application to the circuit court, c) a copy of the transfer agreement, d) a copy of the disclosure statement, d) notification that any interested party is entitled to support, oppose, or otherwise respond to the transferee's application, either in person or by counsel, by submitting written comments to the court and/or by participating in the hearing, f) notice of the time and place of the hearing, and g) notification of the manner in which and time by which written responses to the application must be filed (this could not be less than 10 days after the service of the transferee's notice), in order to be considered by the court.

Protected Party Waivers and Consent. All protected parties would have to provide, in writing, an irrevocable consent to the transfer, a waiver of all rights under each contractual transfer, a waiver of all rights with respect to the transferred payments, and a release

of all claims against the other protected parties with respect to the transferred structured settlement payments. Protected parties would mean the payee, his or her dependents and beneficiaries designated to receive payments following the payee's death, an annuity issuer, a structured settlement obligor, and any other party (including third party beneficiaries) entitled to invoke the benefit of a contractual assignment restriction. However, a protected party could only waive those rights that he or she was allowed to waive under the act and could not waive the requirements of the act. Furthermore, a contractual assignment restriction could only be waived in writing.

The transferee of a structured settlement payment would be required to obtain and file signed originals with the court of the consents and waivers of all of the protected parties (including the annuity issuer and structured settlement obligor). The transferee would also have to provide signed originals of the consents and waivers to the annuity issuer and the structured settlement obligor and provide copies of the consents and waivers to any protected party who requested them.

BACKGROUND INFORMATION:

Tax Treatment of Structured Settlements. The following is excerpted from the testimony of Joseph M. Mikrut, tax legislative counsel for the U.S. Department of the Treasury, before the Subcommittee on Oversight of the House Committee on Ways and Means, given March 18, 1999.

Since 1983, section 130 and other provisions of the Internal Revenue Code have contained a series of special tax rules intended to facilitate the use of structured settlements to resolve physical injury damage claims.

Structured settlements that qualify for this favorable tax treatment typically have the following characteristics: A tortfeasor [a person who is liable for injury] who is required (whether by suit or agreement) to pay damages to a physically injured person enters into a structured settlement agreement with the injured person and a structured settlement company ("SSC"), under which terms the SSC is to pay the injured person specified amounts for a number of years or for the life of the injured person. Pursuant to the agreement, the tortfeasor pays a lump sum to a structured settlement company ("SSC"), which assumes the tortfeasor's liability to the injured person. The SSC purchases an annuity contract to fund the liability, and uses the

annuity payments received under the annuity contract to pay the amounts due to the injured person.

The tax results of the structured settlement arrangement are as follows: The tortfeasor [the person who is liable for injury] is permitted immediately to deduct the lump sum paid to the SSC, but the SSC does not include in income the amount received from the tortfeasor to the extent that such funds are used to purchase the annuity contract. The earnings on the annuity contract are taxed to the SSC according to the favorable rules generally applicable only to individual annuity holders. These rules generally defer taxation of income under the annuity contract until such time that the SSC actually receives annuity payments, at which time the SSC is eligible for a corresponding offsetting deduction for the amounts paid to the injured person. Furthermore, the injured person is not taxed on any amounts received from the SSC, even though significant portions of such payments are funded through the SSC's investment earnings. Taken together, these rules effectively provide that the earnings on funds set aside for the injured person are never subject to tax.

Prior to 1983, the Treasury Department and Internal Revenue Service had taken an administrative position similarly exempting the injured person from tax on the earnings on certain funds set aside on his or her behalf. See, e.g., Rev. Rul. 79-313, 1979-2 C.B. 75. The legislative history to the rules enacted in 1983 explains that the statutory changes were intended, at least in part, to provide statutory certainty that the injured person was not subject to tax on the earnings from qualified structured settlements. In addition, the legislation removed potential tax impediments with respect to SSCs. See H. Rpt. No. 97-832, 97th Cong., 2d Sess. 4 (1982); S. Rpt. No. 97-646, 97th Cong., 2d Sess. 4 (1982). Congress conditioned the favorable rules on a requirement that the periodic payments cannot be accelerated, deferred, increased or decreased by the injured person. Both the House Ways and Means and Senate Finance Committee Reports stated that "the periodic payments as personal injury damages are still excludable from income only if the recipient taxpayer is not in constructive receipt of or does not have the current economic benefit of the sum required to produce the periodic payments."

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Since 1983, Congress has further expressed its support of structured settlement arrangements. In the Taxpayer Relief Act of 1997, Congress extended the section 130

exclusion to cover qualified assignments of liabilities arising under workmen's compensation acts. In deciding to extend such favorable tax treatment, "the Committee was persuaded that additional economic security would be provided to workmen's compensation claimants who receive periodic payments if the payments are made through a structured settlement arrangement, where the payer generally is subject to State insurance company regulation that is aimed at maintaining solvency of the company, in lieu of being made directly by self-insuring employers that may not be subject to comparable solvency-related regulation." See H. Rpt. No. 105-148, 105th Cong., 1st Sess. 410-11 (1997).

FISCAL IMPLICATIONS:

Fiscal information is not available.

ARGUMENTS:

For:

The growth of factoring companies and the lack of regulation regarding such transactions has lead to abuses that undermine the benefits of structured settlements. Horror stories abound - in its January 25, 1999 issue, US News & World Report published an article profiling, among others, an individual who sold \$198,000 in structured settlement payments for \$54,000; another person who sold more than \$71,000 in payments for \$37,500; another who sold \$67,500 of payments for \$16,100. These individuals and many others receive payouts that are significantly less than the present value of their remaining payment. Proponents of regulation of factoring transactions note that it is not uncommon for an injured victim to receive a lump sum that is half or less than half of the present value of the payments being sold. Just as lump sum payments are frequently dissipated, all too often the lump sum received from the factoring company is too quickly spent, and the injured person finds himself or herself in the very predicament that the structured settlement was intended to avoid. In fact, the risk of dissipation is exacerbated by the fact that the lump-sum payment received in a factoring transaction is so sharply discounted.

Proponents point out that the bill would protect parties to existing structured settlements and vindicate the long-standing public policies that favor structured settlements. Further, the bill is limited in its application, it doesn't bar factoring transactions, it merely protects consumers from the more egregious behavior of some of those companies.

Proponents also note that currently these transactions are wholly unregulated and present the risk of serious complications for the parties involved. It is argued that these transactions could result in tax consequences for both the persons making and those receiving the structured settlement payments. Structured settlements are subject to special tax provisions that benefit both the injured victim and the structured settlement company. However, these benefits come with certain restrictions, and the sale of the injured party's rights to payment could be interpreted as violating those restrictions. The present law is unclear, but factoring transactions create a risk that the special tax treatment accorded to the original structured settlement would no longer apply after the factoring transaction.

Even if a determination is made that factoring transactions do not result in any tax consequences, it has been suggested that factoring transactions undermine the purpose of the special favorable tax rules applicable to structured settlements, and as a result the current state of affairs affords favorable tax treatment without ensuring that the legislatively-intended conditions for such treatment are satisfied – thereby costing federal revenues without ensuring that the goal of long-term income protection for injured persons is achieved.

Furthermore, the lack of regulation creates a risk of double liability for the insurance companies involved in these settlements. Proponents cite a Florida case where payments under a worker's compensation settlement were made to a factoring company. However, the sale of the payments was in violation of Florida law and the worker's compensation insurer was ordered to make the same payments to the claimant.

The tax risks and the risk of double liability are risks that structured settlement companies seek to avoid by entering into structured settlements. This uncertainty could lead to the use of fewer structured settlements and recreate the problems that existed before the laws changed to encourage the use of structured settlements.

Against:

Factoring companies provide a valuable service, refinancing settlement payments when an individual's circumstances change sufficiently to warrant the need for a lump-sum payment. Once a person agrees to a structured settlement, he or she is stuck with that

decision. Changes in circumstances (death, divorce, serious illness, etc.) do not and cannot alter the manner and timing of the payments the individual receives. People who face financial emergencies (unexpected medical procedures, bankruptcy, foreclosure, etc.) would be unable to access their funds to meet the demands of that emergency without factoring transactions.

In fact, evidence of the need for factoring companies is also contained in the same US News & World Report article as cited by proponents of the bill. The article notes that the basic flaw of structured settlements is that they are inflexible. For every anecdotal story of someone who sold his or her right to payments for a song or spent the money frivolously, there is one like the Ohio customer who sold a portion of her settlement payments in order to pay her mortgage and avoid foreclosure, or the person from New York who used the money he received from a factoring transaction to expand his business. In these cases and others, the company paying the settlement was unable to help when the individual's circumstances changed and the injured party needed a lump-sum more than he or she needed a future payment.

Opponents of the bill point out that the horror stories are not representative of the bulk of factoring transactions. A survey performed by the National Association of Settlement Purchasers indicated that 92 percent of those people who sold their structured settlement payments were "satisfied" or "very satisfied" with the refinancing they received. They also point out that on average, a seller of structured settlement payments is 33 years old, employed, and has an annual household income of nearly \$25,000. Some 85 percent of structured settlement claimants are not disabled and are gainfully employed. Further they argue that the money the factoring company pays to claimants is not wasted – 34 percent of the claimants use the money to buy a home, 31 percent use it to pay off existing debts or educational expenses, and 16 percent use it to open or expand a business.

Finally, opponents of the bill also point out that most structured settlements are agreed to without court review. Often the settlement is reached before the injured party has retained counsel. In reaching these settlement agreements, the defendants and their insurers are not required to disclose the present value of the future payments they are offering to the injured party. Thus, if a court was not involved in the settlement agreement, there should be no need that a court take part in a factoring transaction based upon that agreement.

Response:

The intent of payments made in settlement of a claim for personal injury is to make the claimant whole - if that can be done at a lower cost to the person or company liable to make claimant whole, what harm is done? The settlement of a claim is not and should not be based on how much the insurer or responsible party can pay (except where punitive damages are being discussed), but on what it will take to make the claimant whole. If the injured party has lost the equivalent of \$1,000 a month of income and had the expectation of making that amount for another 20 years, no harm is done if the person who is liable for the payment on that injury is able to make those payments for less than the \$240,000 that those payments represent.

If an injured party feels that he or she is not being offered fair value for his or her injury, he or she is not required to accept a settlement offer and may bring the matter to court. The issue the injured party should weigh when deciding whether to accept a settlement offer is whether the amount he or she would receive would be adequate payment for his or her injury, not how much that payment would cost the defendant.

Against:

Opponents of the bill argue that the bill is too expansive. For example, it is argued that the bill would interfere with the ability of a person who was receiving structured settlement payments to obtain a loan from a bank. By covering not only sales and transfers of a payment right, but also pledges, hypothecations, or encumbrances the bill would force a person to obtain a court's permission before he or she could use that payment as security for a loan.

Opponents also argue that the bill applies a far too restrictive standard of review to test the need for an individual to transfer a payment right. The bill would require that the person show that he or she is facing imminent financial hardship in order to justify the sale of a structured settlement payment right. Several other states (California, Georgia, Minnesota, Illinois, North Carolina, Pennsylvania, Virginia) have adopted a less restrictive standard, "the best interests of the consumer."

Further, it is argued that preventing a transfer if all protected parties do not give consent to the transfer

creates a veto power on the part of the insurance companies.

POSITIONS:

The National Structured Settlement Trade Association supports that bill. (3-13-00)

The Michigan Brain Injury Providers Council supports the bill. (3-13-00)

The Alliance of American Insurers supports the bill. (3-13-00)

The Michigan Trial Lawyers Association supports the bill. (3-13-00)

The Michigan Insurance Federation supports the bill. (3-13-00)

AAA Michigan supports the bill. (3-13-00)

The American Council of Life Insurance supports the bill. (3-13-00)

The National Association of Settlement Purchasers opposes the bill. (3-13-00)

Analyst: W. Flory

■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.