

Recession's Effect on Settlement and Fees

Does it still make sense to structure settlements and fees in an environment of upcoming higher inflation, higher interest rates and higher taxes? The answers are different for settlements than they are for fees.

The fiscal policy responses to the recession of 2008/2009 create a financial environment different from any we have experienced in the last 30 years when structured settlements and fees flourished.

First, the Federal Reserve has been increasing the money supply as a response to the recession. The increased supply of money currently in the system is already resulting in higher import prices and higher oil and gold prices. The Fed will begin its effort to decrease the money supply when the recovery is established, but the success of the timing of the removal of so much new money will determine the level of inflation. Early removal can increase the duration of the recession. Late removal can result in inflation. While no one is predicting high inflation, the annual increase in prices is likely to be in the 1 percent to 3 percent range for the intermediate term and much higher for the longer term.

Higher inflation militates toward receiving a lump-sum settlement. For a severely injured plaintiff with many years of life expectancy, inflation's erosion of the value of future payments could restrict financial flexibility in later years. Equities are traditionally used as inflation protection.

The initial step in planning the investment of any large settlement should be an allocation of the settlement among asset classes. For example, a portion might be invested in equities to protect from inflation and a portion invested in income securities. Within the income allocation, a portion might be invested for taxable and a portion for nontaxable income. For that reason, financial planners argue that a structured settlement should be used solely to fund the nontaxable income portion of an asset allocation. The same is true with respect to structuring attorney's fees.

The attorney, however, often causes the structured settlement broker to be the first (and often only) advisor a plaintiff encounters. Structured settlement brokers have only one product to sell. Thus, attorneys should be sure that complete financial planning is available to the plaintiff to assure that meaningful inflation protection is offered.

There are three forms of annuities and bonds that fund structured settlements and fees that offer some inflation protection. Metropolitan Life Insurance Co. provides a variable annuity for 50 percent of the payments to be received (not available for fees). Possibly a Treasury Inflation Protection bond product could be found. A plaintiff or attorney can also purchase a fixed-yield curve annuity in payments as part of a structure. That fixed percentage is expensive, however, and is no match for variable inflation over a 20- or 30-year period. An attorney also needs inflation protection, although an attorney's ability to continue to earn fees in the future offsets the inflation erosion of future payments somewhat.

Second, interest rates will rise as the heavy federal borrowing to finance the policy responses occurs, resulting in a projected \$9 trillion deficit. The currently steep yield curve suggests that the short-term rates, controlled by the current low federal funds rate, will increase steeply as maturities increase. That is an expectation of economic recovery, higher interest rates for longer-term investment, and inflation.

Higher interest rates also militate toward receiving a lump-sum settlement and using a structured settlement solely to fund the nontaxable income portion of an asset allocation. The same is true with respect to structuring attorney's fees.

Interest rates for both structured settlements and attorney fee struc-



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tures are at historical lows. If they rise, as they are expected to, then a plaintiff structuring a settlement and an attorney structuring a fee currently will not be in a position to take advantage of those increased rates. That again suggests allocating a lump sum among equities and income and using the structured settlement to fund the nontaxable portion of the income allocation and using the structured fee to fund the taxable portion of the income allocation. In an environment of uncertain (and especially rising) interest rates, the lump-sum portion of a settlement and of fees should be invested in debt instruments with staggered maturities to utilize those higher rates as they arrive.

Third, federal income taxes will rise. Tax rates are low compared to other developed countries. On average, the other 30 developed countries receive about 35 percent of their gross domestic product in income taxes. The United States receives about 27 percent. While that alone is not a reason to expect higher taxes, the deficit in the United States is such a reason. In addition, the Bush tax cuts will expire at the end of 2010. The Obama administration is likely to permit them to do so. That alone will increase the top tax bracket from 35 percent to 39.6 percent for families with incomes above \$250,000.00. While we also expect higher payroll taxes to finance health care and Medicare, payroll taxes are not a factor in the decision to structure settlements, but they are in the decision to structure fees.

Higher taxes may or may not militate toward structuring the settlement. That is so because the income earned by investing a lump sum settlement will be taxed at higher rates in the future. Often, however, the plaintiff has little other income and has high medical expenses, eliminating that higher future tax rate. To quadriplegics and paraplegics receiving large settlements, for example, the increased taxes may not be a factor in making the decision since the proceeds of their investment of a lump sum may suffer little tax after deducting medical expenses. For a plaintiff that continues working and will therefore pay higher taxes, the structured settlement is an advantage. Thus, for such a plaintiff, there is no substitute for running the future tax liabilities as far out as possible to quantify the effect of the decision to structure.

Higher taxes put an attorney in a much different position than the client. The fee will be taxed at the income tax rate in effect during the year the fee is received. Thus, the expiration of the Bush tax cuts in 2011 and any other increasing income taxes will take a larger share of future fee payments.

In addition, structuring fees results in higher payroll taxes and those taxes are going up. The attorney's share of payroll taxes is currently 6.2 percent of the first \$106,800 each year (increasing to include amounts over \$250,000.00 under the Senate health care plan) plus 1.45 percent (increasing to 1.96 percent under the Senate health care plan) of all of your income for the year, plus 0.8 percent of the first \$7,000 during the year. If you are self-employed, those amounts are doubled. If you structure your fee, then you pay those payroll taxes every year that you receive a payment. Increasing payroll taxes will compound the negative results.

Finally, a reason cited to structure settlements (but not fees) is the spendthrift protection provided from imprudent investments of the lump-sum settlement. Literature often cites a study demonstrating that some high percentage of lump sums is dissipated after five years. Apparently, however, no such study exists. Since we relied on such a study to conceive and draft the structured settlement law and testify before Congress, we are somewhat embarrassed by that fact. Nevertheless, it remains true that large settlements do attract predatory relatives and investment advisors irresistible to some plaintiffs. Spendthrift protection is a good thing for such plaintiffs. Minors and incompetents also need that spendthrift protection. Of course, any plaintiff whose settlement is in a trust with a professional trustee, such as a special needs trust or an irrevocable trust, does not need such protection.

In sum, consider carefully the effect on your client and yourself of future higher inflation, higher interest rates and higher taxes. Do pro forma projections. Involve professionals with more than structured settlements to sell. Make an informed decision for your client and for yourself.



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