Structured settlement annuities: Safety through Oversight and Protection from Legal Process

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Structured settlements utilizing life insurance annuities as their funding mechanism have been around for three decades. Over half a million injury victims receive benefits from structured settlement annuities. Each year life insurance companies that provide structured settlements receive more than $6 billion to fund new structured settlement arrangements and an estimated $100 billion has been paid in total to fund structured settlements in force today.[1] Structured settlements are utilized in the settlement of tort claims because of the advantages it offers like tax-free payments[2], fixed annuities not subject to large market fluctuations, they provide guaranteed lifetime income, have inherent spendthrift protection as well as creditor protection and avoidance of guardianship requirements in certain cases. Structured settlements offer the unsophisticated investor the ability to make a onetime simple investment decision that will provide competitive returns without market risk and no taxation. Similarly, for sophisticated investors they can use the annuity as a funding mechanism for other market based investments using a dollar cost averaging approach.

However, recent market events have had many people question any type of investment including structured settlement annuities. Nevertheless, structured settlement annuities remain a safe and a viable vehicle to protect injury victims. This article will explore some of the safeguards that are in place to protect structured settlement recipients.

Government Oversight of Life Insurance Companies

The financial market events of late 2008 were historic and unprecedented. The near collapse of AIG, one of the world's largest companies and a top insurance company conglomerate, is and was a sign of the times. The impact of AIG's problems on our financial markets illustrates how quickly things can spiral downward. However, it also illustrates that structured settlements are still quite safe for personal injury victims given the alternatives in today's market. Imagine those injury victims who were heavily invested in the stock market during recent downturns needing to withdraw large amounts from their accounts for a needed experimental medical treatment or a handicapped vehicle. It would have been bad timing to have to get money out of the market while a structured settlement would not have been impacted by these financial events.

Given everything that has occurred recently, some have questioned whether life companies that provide structured settlements would or could possibly collapse. Certainly AIG's financial issues impacted the credit rating of their life company, American General. American General was downgraded from A+ to A by A.M. Best as a result of AIG's financial issues. However, AIG's life company is a separate company domiciled in Texas and regulated by the Texas

Department of Insurance. Life insurance companies are regulated by their domicile state's department of insurance. The National Association of Insurance Commissioners (NAIC) issued a statement after the near collapse of AIG which stated the following:

> "As a holding company, AIG is a separate, federally regulated legal entity that is distinct and apart from its subsidiary insurers. The subsidiary insurers are governed by state laws designed to protect the interest of policyholders. State insurance regulators are committed to protecting the interest of policyholders and will work closely with AIG management and other regulators to fulfill this commitment. The No. 1 job of state insurance regulators is to make sure insurance companies operate on a financially sound basis. If needed, we immediately step in if it appears that an insurer will be unable to fulfill the promises made to its policyholders. This includes taking over the management of an insurer though a conservation or rehabilitation order, the goal being to get the insurer back into a strong solvency position."

> "State regulators have numerous actions they can take to prevent an insurer from failing. Claims from individual policyholders are given the utmost priority over other creditors in these matters – and, in the unlikely event the assets are not enough to cover these claims, there is still another safety net in place to protect consumers: the state guaranty funds. These funds are in place in all states. If an insurance company becomes unable to pay claims, the guaranty fund will provide coverage, subject to certain limits."

In the case of American General, they have been in business since the 1920s. They were acquired by AIG only in the recent past (2001). There was never any indication of any financial issues with American General. It is understandable why there were fears over American General given AIG's well publicized financial crisis. However, as the NAIC statement explains the life company, as with all life insurance companies, is highly regulated by state insurance regulators whose goal is to protect consumers who have policies.

The problems that AIG experienced were due to other sectors of the company which were impacted by the slumping housing market and foreclosures. AIG is the only company that has a life insurance company which provides structured settlements that was heavily involved in this problematic sector of the market. Other life insurance companies, such as New York Life, John Hancock Life, Pacific Life, MetLife and others have little or nothing to do with these markets and their financial ratings remain very, very strong.

In addition to oversight by insurance commissioners and state departments of insurance, state laws require life insurance companies to maintain reserves for every obligation they undertake and regulate the types of investments a life company can make. According to the National

Structured Settlement Trade Association (NSSTA), “more than two-thirds of the investments corresponding to a life insurer’s required reserves are held in ‘investment grade’ bonds, with less than five percent in the stock market.” On top of reserves, life insurance companies must maintain a surplus of additional funds to meet their future obligations. There are certain ratios that are considered healthy in terms of assets to liabilities. NSSTA points out that the “American Council of Life Insurers, in a recent survey, their members’ average surplus ratio actually stood at a factor of over four” while assets of two and a half times liabilities are considered healthy.

A discussion about the protections in place for structured settlement annuities would not be complete without a discussion of the state guaranty funds[3]. According to the National Organization of Life & Health Insurance Guaranty Associations (NOLHGA), state life and health guaranty associations are state entities instituted to protect insurance policyholders of insolvent insurance companies. There is a state guaranty association in all fifty states as well as Puerto Rico and the District of Columbia. NOLHGA explains that “[t]he guaranty association cooperates with the commissioner and the receiver in determining whether the company can be rehabilitated or if the failed company should be liquidated and its policies transferred to financially sound insurance companies.” Once a “liquidation is ordered, the guaranty association provides coverage to the company’s policyholders who are state residents up to the limits specified by state laws.”[4]

The National Structured Settlement Trade Association explained the interplay of the state guaranty associations and two past failures of life companies in the 1980s. According to Randy Dyer, former Executive Director of NSSTA:

> “If any carrier becomes insolvent, the guaranty association assesses its members against a predetermined formula to make up the shortfall. The variables in each state include the coverage limit; the trigger and definition of who is covered. Most states use a $100,000 limit though some offer $300,000 or $500,000 for annuities, including structured settlement annuities. The limit refers to the present value of the remaining future stream of payments at the time of the insolvency. Most states trigger the coverage with insolvency. Some few use a somewhat lower standard.
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> In practical terms, the guaranty associations fund the transfer of obligation from an insolvent insurer to a solvent insurer. The classic case was the Canadian company, Confederation Life. When Confederation was taken into conservation by the Canadian government, the US regulators separated the US business from the parent company. Each block of business was grouped and assigned a pro rata share of the assets. The block of assets and liabilities in each line of business was then sold at auction to the highest bidder (which is to say, the company willing to take the least assets in order to guaranty 100% payments to all policyholders in

> that line of business. The prize business, life insurance and investment products, is sold first. Since those contracts represent an ongoing stream of premiums or payments, companies are willing to take fewer assets in order to secure the business. The excess assets are then poured over the other lines of business. The single premium business is sold last, by which time it is covered by the maximum amount of assets. If there is any shortfall, the guaranty funds step in to fill the gap. It is relatively rare for guaranty funds to have to do more than finance the process and recoup their investment once all policyholders have been guaranteed 100% payments. In the case of the kind of highly rated companies associated with structured settlements it is rarer still.
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> Only once in the history of the guaranty funds has a shortfall continued to exist at the end of the above process. That was the case of Executive Life of California which fell victim to the junk bond craze of the mid-1980's. First Executive Corp, ELIC's parent was holding some 13,000 structured settlements when it was taken into conservation. Of those, 8,000 were covered 100% by ELIC's assets. Of the remaining 5,000, 3,500 were covered by a combination of ELIC's assets and the guaranty fund coverage. Another 1,100 policies were made whole by a combination of the above and shortfall payments made by property casualty insurers. The remaining 300 annuitants recovered an average of 92 cents on the dollar."

Executive Life is the only circumstance since the inception of structured settlements where anybody who accepted a structure received less than they were supposed to get from their life insurance annuity policy. Given that there are more than 500,000 structures in force around the world, the fact that 100% of structured settlement payments have been made and only 1% of payments were altered even after insolvency is a testament to their safety. Companies who write structure settlement annuity policies represent the top two percent of all life and annuity companies in the country and offer the highest possible protection for injury victims. There will always be some amount of risk no matter how an injury victim invests their settlement proceeds, but structured settlements annuities are by far the safest alternative from a risk standpoint.

Obviously care and thought should be given to how to construct a structured settlement plan for an injury victim. Diversification and creating overlapping income streams with different companies may be advisable depending on the circumstances. Careful analysis regarding the financial strength of the life insurance companies proposed for an injury victim is also of paramount importance. There are several rating services that evaluate the strength of life insurance companies that offer structured settlements. The primary rating service is A.M. Best and their top rating is A++. The other important rating service is S&P whose top rating is AAA. While companies rated A+ by A.M. Best or AA by S&P are still excellent companies, depending on risk tolerance of the client and concerns about security, a client might want to go with a company like John Hancock. John Hancock is rated A++ by A.M. Best and AAA by S&P the highest possible rating for financial security by both rating services. Another alternative would be to place portions of the settlement with John Hancock, New York Life and Pacific Life, the top three rated life insurance companies that offer structured settlement annuities. It could be split a third to each company or weighted towards whichever company has the best deal for the client.

As part of the ratings analysis process, consideration should also be given to the types of investments that a life insurance company makes with its assets. For example, New York Life (rated A++ by A.M. Best and AAA by S&P) has a total of $104 billion invested assets. Bonds make up the largest percentage of their invested assets at 63.6% (of that 69.5% were class 1 highest quality bonds and 23.9% were class 2 higher quality bonds). Mortgages make up a rather small percentage of their invested assets at 8.7% (however 0.0% were classified as "problem mortgages"). In addition, there is a ratio of assets to liabilities measurement that is also important to consider in these turbulent financial times. New York life's ratio is very high meaning they are very well capitalized as one would expect given their financial ratings. This information is available from services that evaluate insurance companies and should be provided by a settlement planner upon request.

To summarize, structured settlement annuities have multiple levels of protection. The first level of protection is oversight by state insurance commissioners. The second level is state law reserve and surplus requirements. The third level of protection is provided by state insurance guaranty associations. Fourth is selection of the best possible combination of life insurance companies that provide structured settlement annuities after analysis of their ratings.

Structured Settlement Protection Acts

After the advent of the "factoring" industry in the early 1990s, nearly every state has passed a structured settlement protection act. The acts protect structured settlement recipients from unscrupulous companies that purchase structured settlements. "Factoring" companies, the name commonly used for companies that purchase structured settlements, buy injury victim's payment streams in return for a lump sum payment to the injury victim. The lump sum payment to the injury victim for their future periodic structured settlement annuity payments is typically at a sharp discount with some discount rates being patently unfair.[5] Given the unsophisticated population selling structured settlements, the amount of advertising by factoring companies and past abuses by factoring companies, many states have enacted Structured Settlement Protection Acts and the Federal government decided to enact protective legislation in the form of Section 5891[6] of the Internal Revenue Code.

Section 5891 of the Internal Revenue Code requires that all structured settlement factoring transactions be approved by a state court, in accordance with a qualified state statute. Qualified state statutes must make certain baseline findings, including that the transfer is in the best interest of the seller, taking into account the welfare and support of any dependents. Failure to comply with these procedures results in the factoring company paying a punitive excise tax of 40% on the difference between the value of the future payments sold and the amount paid to the person who wanted to sell.

State legislatures began enacting protective legislation, called Structured Settlement Protection Acts, for structured settlements in 1997[7]. While the state Structured Settlement Protection Acts vary, they are based on a model act and most contain similar provisions. All of the acts mandate court approval of any proposed sale with a best interests finding, most impose numerous procedural requirements and call for full disclosure of the terms of the transaction. A New York case denied a petition for approval of a “factoring” transaction under the state’s structured settlement protection act because of the unfair nature of the deal, lack of a plan for the lump sum to be received and it did not serve the payee’s best interests.[8] Judge Alice Schlesinger explained, in denying the approval of the sale, that “[t]he Act, similar to others nationwide, was designed ‘to protect the recipients of long-term structured settlements from being victimized by companies aggressively seeking the acquisition of their rights’.”

Other courts that have interpreted the various state acts have found that they are “designed to protect beneficiaries of structured settlements from being taken advantage of by others.”[9] The best interests’ standard was described by a Pennsylvania court as admitting “the reality that a person’s judgment is often clouded by the lure of quick cash; and insures that the public policy considerations involving structured settlements are not usurped by organizations that lure people into assigning future payments for far less than their actual value.”[10]

Similarly, cases have held the structured settlement payment acts prevent garnishment of a structured settlement annuity. In a Pennsylvania case, the court held that a creditor’s alleged security interest and garnishment of a structured settlement annuity violated the state’s Structured Settlement Protection Act.[11] In interpreting the Pennsylvania Structured Settlement Protection Act, the court determined that garnishment was encompassed by the broad meaning of the word “transfer” in the act.

Another important note is anti-assignment provisions found in many structured settlement agreements. Most settlement releases of tort claims where a structured settlement will be implemented contain an anti-assignment provision. This provision typically states that “the periodic payments cannot be accelerated, deferred, increased or decreased by claimant or any payee; nor shall claimant or any payee have the power to sell, mortgage, encumber, or anticipate the periodic payments, or any part thereof, by assignment or otherwise.” Most state courts have held that the common law and contract rights relating to these provisions are not superseded by enactment of Structured Settlement Protection Acts.[12] Accordingly, courts have blocked the sale of structured settlements even though they complied with the state act because it would be barred by the anti-assignment clause found in the settlement documents.[13] There is model language that can be inserted into a settlement agreement that would allow for factoring, if desired, but requiring it comply with IRC 5891 and relevant state Structured Settlement Protection Acts.[14]

Most states impose fines and provide civil remedies for failure to comply with the state Structured Settlement Protection Act. Some deem a violation of the statute as a violation of the Unfair Trade Practices and Consumer Protection Law.[15] In addition, there is the 40% excise tax imposed by IRC 5891 for failure to comply with the state Structured Settlement Protection Act.[16]

The Structured Settlement Protection Acts provide significant protections for structured settlement recipients against factoring transactions and have in some instances prevented the sale of a structured settlement completely. These laws are a further protection of structured settlement recipients and illustrate the government's recognition of their value to injury victims.

Protection from Creditors, Bankruptcy & Divorce

Oftentimes the protection that structured settlement annuities are afforded under the law in terms of judgments and creditor claims is overlooked when analyzing whether to implement one. However, this feature is very important for injury victims who need to protect their recovery. Injury victims only get one opportunity to recover for their injuries. If someone who recovers for their injuries is subsequently involved in an accident where they injure someone else or someone is injured on their property, bank accounts and most investments are exposed to claims. In addition, if an injury victim gets into debt and has creditors making claims, their assets could be exposed to these claims.

However, many states have either common law or statutes that protect annuities from legal process. For example, in Florida there is a statute[17] that completely exempts annuities from creditors and judgments. This statute gives injury victims an option to completely protect their settlement proceeds from judgments or creditor claims by entering into a structured settlement annuity as part of their settlement. That statute has been interpreted by Florida courts[18] to defeat judgment creditor claims against structured settlement annuities.

In addition, structured settlements offer enhanced protection in case of divorce or bankruptcy. Structured settlements are not owned by the injury victim. Instead, the injury victim is the payee and the life insurance company's assignment company owns the annuity. When a structured settlement is created as part of a settlement an assignment is done. The assignment is done to transfer ownership of the annuity from the purchaser, the defendant, to the life company assignment corporation. The assignment corporation takes on the obligation to make the future periodic payments and purchases an annuity from the annuity issuer. Because of this legal arrangement, structured settlement annuities are not an asset owned by an injury victim.

Consequently, it is not an asset that can generally be divided in the case of divorce.[19] The income that it produces can be considered in determining alimony, but the asset itself usually is not divided.[20] Similarly, a structured settlement annuity is not an asset generally reachable in cases of bankruptcy.[21]

Conclusion

Given the safety and security structured settlement annuities provide they should be considered as part of any sound financial plan for an injury victim. The oversight by state insurance commissioners and state laws provide annuity policyholders with significant safeguards over their structured settlements. State insurance guaranty associations provide an extra layer of protection for structured settlement recipients. The enhanced protection from judgments (including divorce), creditors and bankruptcy enjoyed by structured settlement annuities makes them an important planning tool for injury victims to safeguard their settlement proceeds. Before deciding to not structure a settlement, careful consideration should be given to these protections and the value they provide to safeguard an injury victim's recovery. An experienced settlement planner can help provide advice on all of these issues and provide information about the benefits of a properly created structured settlement plan.

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[1] Hindert & Ulman, Transfers of Structured Settlement Payment Rights: What Judges Should Know About Structured Settlement Protection Acts, 44 NO. 2 Judges' J. 19 (2005).

[2] See IRC Section 104(a)(1) & (2). See also Revenue Ruling 79-220 (July 1979)

[3] See Florida Statute 631.717 for information on coverage of annuities in the state of Florida by the Guaranty Association.

[4] According to NOLHGA, "when an insurer fails and there is a shortfall of funds needed to meet the obligations to policyholders, state guaranty associations are activated. To amass the funds needed to protect the state's policyholders, insurers doing business in that state are assessed a share of the amount required to meet all covered claims. The amount insurers are assessed is based on the amount of premiums that they collect in that state."

[5] See J.G. Wentworth S.S.C. v. Jones, Jefferson Cty., S.W.3d 309, 315 (Ky. Ct. App. 2000) ("[i]n the four cases here the rate of return to Wentworth varied between 36 and 68 percent per year"); Windsor-Thomas Group Inc. v. Parker, 782 So.2d 478 (Fla. 2d DCA 2001) (finding that from "a functional viewpoint, this agreement is a secured promissory note with an annual interest rate of approximately 100 percent.").

[6] 26 U.S.C. §5891

[7] Illinois was the first state to enact a structured settlement protection act. Hindert & Ulman, Transfers of Structured Settlement Payment Rights: What Judges Should Know About Structured Settlement Protection Acts, 44 NO. 2 Judges' J. 19 (2005).

[8] Petition of 321 Henderson Receivables, L.P. V. Martinez, 816 N.Y.S.2d 298 (2006) (holding "proposed sale of payee's structured settlement payments was not fair and reasonable and did not serve best interest of payee, and thus could not be approved pursuant to Structured Settlement Protection Act").

[9] In re Benninger, 357 B.R. 337 (Bankr. WD. Pa. 2006).

[10] In re Hilton, No. 2005-2721, 2005 WL 4171289, 2005 Pa. Dist. & Cnty. Dec. LEXIS 392 (2005).

[11] In re Benninger, 357 B.R. 337 (Bankr. WD. Pa. 2006).

[12] *See generally* Rapid Settlements, Ltd. v. Dickerson, 941 So.2d 1275 (Fla 4th DCA 2006) (holding assignment of payments was prohibited under settlement agreement); Bobbitt v. Safeco Assigned Benefits Service Co., 25 Conn. L. Rptr. 324, 41 U.C.C. Rep. Serv. 2d 942 (Conn. Super. Ct. 1999) (holding Structured Settlement Protection Act did not abrogate the anti-assignment provision in the release and enforcing anti-assignment provision); In re Foreman, 365 Ill. App. 3d 608, 302 Ill. Dec. 950, 850 N.E.2d 387 (2d Dist. 2006) (rejecting a petition by factoring company under the Illinois Structured Settlement Protection Act for court approval of factoring transaction and holding anti-assignment provision in release prohibited transaction).

[13] *Id.*

[14] Suggested model language is as follows: **"**None of the Periodic Payments and no rights to or interest in any of the Periodic Payments (all of the foregoing being hereinafter collectively referred to as "Payment Rights") can be accelerated, deferred, increased or decreased by any recipient of any of the Periodic Payments; or sold, assigned, pledged, hypothecated or otherwise transferred or encumbered, either directly or indirectly, unless such sale, assignment, pledge, hypothecation or other transfer or encumbrance (any such transaction being hereinafter referred to as a "Transfer") has been approved in advance in a "Qualified Order" as defined in Section 5891(b)(2) of the Code (a "Qualified Order") and otherwise complies with applicable state law, including without limitation any applicable state structured settlement protection statute. No Claimant or Successor Payee shall have the power to effect any Transfer of Payment Rights except as provided in sub-paragraph (ii) above, and any other purported Transfer of Payment Rights shall be wholly void. If Payment Rights under this Agreement become the subject of a Transfer approved in accordance with sub-paragraph (ii) above the rights of any direct or indirect transferee of such Transfer shall be subject to the terms of this Agreement and any defense or claim in recoupment arising hereunder."

[15] *See* 40 P.S. § 4007 (P.A. 2000)

[16] 26 U.S.C. §5891

[17] Florida Statute 222.14 - **Exemption of cash surrender value of life insurance policies and annuity contracts from legal process:** The cash surrender values of life insurance policies issued upon the lives of citizens or residents of the state and the proceeds of annuity contracts issued to citizens or residents of the state, upon whatever form, shall not in any case be liable to attachment, garnishment or legal process in favor of any creditor

of the person whose life is so insured or of any creditor of the person who is the beneficiary of such annuity contract, unless the insurance policy or annuity contract was effected for the benefit of such creditor.

[18] *See* Windsor-Thomas Group Inc. v. Parker, 782 So.2d 478 (Fla. 2d DCA 2001). Judgment creditor brought action to garnish annuity that funded structured settlement of tort case in favor of the judgment debtor. The ***issuer*** moved to quash the writ based on the statutory prohibition that annuity contracts are not liable to attachment, garnishment, or legal process in favor of any creditor. The Circuit Court dissolved the writ. Creditor appealed. The District Court of Appeal held that the issuer had standing to raise the statutory prohibition against garnishment.

[19] *See generally* Krebs v. Krebs, 435 N.W.2d 240 (Wis. 1989)

[20] *See generally* Ihlenfeldt v. Ihlenfeldt, 549 N.W.2d 791 (Wis. App. 1996)

[21] *See* In re McCollam, 612 So.2d 572 (Fla. 1993). Annuity was exempt under Florida Statute 222.14 from creditor claims in bankruptcy action. *See also* In re Orso, 283 F.3d 686 (5th Cir. 2002) (holding structured settlement "annuity contracts under which payments were owed came within scope of Louisiana statute exempting such contracts from the claims of creditors"); In re Belue, 238 B.R. 218 (S.D. Fla. 1999) (holding "debtor who was named, as payee and intended beneficiary, under annuity purchased by insurance company to fund its obligations under structured settlement agreement was entitled to claim annuity payments as exempt under special Florida exemption for proceeds of any annuity contracts issued to citizens or residents of state . . . ."); In re Alexander, 227 B.R. 658 (N.D. TX 1998) (holding structured settlement annuity paid to debtors following the death of their children in automobile accident was entitled to exemption as an annuity under Texas law).

