Mueller Prost PC
CPAs + Business Advisors

ATTORNEY'S REPORT

QUALIFIED SETTLEMENT FUNDS

Add Some Structure to Your Settlements

You've just won the case. After years of litigation, a $3 million settlement has finally been obtained on your client's personal injury claim.

Now, of course, everyone wants their money. As plaintiff's attorney, you're feeling the pressure of dealing with a complex array of issues.

The plaintiff faces both Medicare and Medicaid liens, and will require a special needs trust. Your client loses potential income each day the distribution is delayed — and negotiations on the Medicare and Medicaid liens could drag on for months. There's also a derivative claim for loss of consortium on behalf of the plaintiff's spouse to be addressed.

And everyone is looking at you to find out how quickly you can tie up the loose ends and get the money distributed.

Some Room to Breathe

Increasingly, attorneys are finding that a Qualified Settlement Fund (QSF) — aka a 468b settlement trust — can provide some breathing room. A QSF essentially "stops the clock" on lawsuit settlement.

Time is no longer a pressing factor for the lien negotiations, allocations and probate proceedings. The settlement can be placed in the settlement trust while other matters are dealt with, such as tabulating the Medicare and Medicaid liens and negotiating for lower amounts.

The plaintiff's attorney now has additional time to obtain a conservator or a guardian in probate court, and to establish a special needs trust if appropriate. And just as important, the attorney can be paid from the trust *immediately*.

Who benefits from a QSF? The short answer: everyone.

The defendant – By paying their share of the agreement into the 468b trust, defendants satisfy the economic performance test and are dismissed from the case with prejudice. Upon payment of the settlement funds into a QSF, the defendant receives an immediate tax deduction of the settlement amount, and has no further responsibility to the plaintiffs. A QSF is also an effective tool to use when there are multiple defendants that do not settle their claims at the same time. All monies can be held in the QSF, or partial distribution can be made to the plaintiffs.

The plaintiff – Plaintiffs receive immediate, flexible control of the funds inside the QSF. They can take their time, carefully selecting among the options of a lump sum payment, structured settlement annuity or a special needs trust. A QSF also avoids any issue with "constructive receipt": Since the funds are held by a separate entity, plaintiffs are not immediately responsible for tax payments.

In addition, a QSF is a handy tool if the claimant is on Medicaid. If the attorney or claimant takes constructive receipt of the funds, Medicaid could deem the settlement funds as a spendable resource and potentially disqualify the claimant from Medicaid. Placing funds in a QSF makes it possible to take the necessary time to craft a special needs trust without the fear of jeopardizing Medicaid eligibility or slowing down the funding of the settlement.

The attorney – The plaintiff's attorney's fees and other expenses can be paid immediately from the 468b fund.

QSF Requirements

Pursuant to Treasury Regulations §1.468B-1(c), a 468b qualified settlement fund must:

Be created by a court or government agency and be subject to continuing supervision by that authority. Note that an arbitration award granted by an

QUALIFIED SETTLEMENT FUNDS

Add Some Structure to Your Settlements, Cont'd.

arbitration panel will suffice as long as the award is judicially enforceable and is issued pursuant to a bona fide arbitration proceeding, and the fund is subject to the arbitration panel's continuing jurisdiction.

Resolve claims related to the subject of the lawsuit. This requirement has been strictly interpreted in United States v. Brown, 2:95-CR; 245 B. In this matter, funds used to reimburse victims of a stock fraud were not held to be a QSF because the fund was created to provide restitution, not to resolve or satisfy a requisite claim.

Qualify as a trust under state law. The QSF must be a trust under applicable state law, or the assets must be kept separate from the assets of the tortfeasor, insurance carrier or other related parties.

Note that a Qualified Settlement Fund cannot be created for liabilities under a Worker's Compensation Act claim or self-insured health plan.

Tax Implications

The economic performance test allows the defendant to pay a settlement into a 468b trust and deduct the claim, even though the payout to or for the benefit of the plaintiff occurs later. However, the 468b trust does not constitute constructive receipt to the plaintiff because of the restrictions placed upon the trust. The plaintiff's attorney does not have custody — an independent trustee owns the funds. This arrangement preserves the opportunity to use the structured settlement annuity option.

A Qualified Settlement Fund is a distinct tax-paying entity (i.e., it is treated like corporations for tax reporting purposes) and is required to:

- File an annual tax return.
- Make timely tax payments.
- Prepare and distribute the appropriate tax forms to employees and asset recipients.

Earnings (dividends, interest, capital gains and losses, carryovers, etc.) are subject to taxation in a manner similar to corporate earnings at the maximum trust tax rate. Settlement trusts are also allowed deductions for administration costs and related expenses, losses sustained in connection with the sale or exchange of property, and net operating losses. Trust distributions to the plaintiffs are not deductible and liability cannot be reduced with tax credits.

The Role of the Trustee

Noncompliance can cause the trust to incur heavy penalties and, in a worse-case scenario, may partially or entirely invalidate the trust. Therefore, an independent, qualified trustee — often an accountant or lawyer — is appointed to handle the trust. The trustee manages the funds, handles ongoing claim resolution, and works with the plaintiffs to determine the trust's payout structure.

QSF legal requirements are vast, detailed and complex. Using an experienced accountant can greatly simplify fund administration and preserve the benefits for all parties.

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New Uses for Settlement Funds

Structured settlements have been around for about 40 years, having been utilized primarily for personal injury cases (both liability and workers compensation) and large class action lawsuits or mass tort cases.

Changes to the Internal Revenue Code (§468B) in 1986 created Designated Settlement Funds (DSFs) and, later, Qualified Settlement Funds. QSFs expanded the range of claims that could be considered, such as tort, environmental, breach-of-contract, violation-of-law and other claims.

BUY-SELL AGREEMENTS:
The Ticking Time Bomb of Succession Planning

It has been said that buy-sell agreements are like nuclear bombs — business owners create them … and then hope they never have to be used.

However, a ticking time bomb is probably the more accurate metaphor.

TICK … TICK … BANG

Buy-sell agreements are typically written early in a company's life — whether it's a partnership between two professionals or a closely held family business involving multiple generations.

Relegated to a dusty shelf, the agreement ticks away until a triggering event occurs — often, the death or disability of an owner. Against the backdrop of some such "unhappy event," all the flaws of the buy-sell agreement are revealed.

The agreement may be poorly conceived and/or written. It may be riddled with ambiguous valuation language and terms. Or, perhaps the purchase price and funding mechanism are not clearly explained. In the end, a poorly crafted buy-sell agreement often results in some unpleasant surprises for at least one party.

WHY BUY-SELL AGREEMENTS FAIL

To understand why buy-sell agreements sometimes fail, it's important to understand the key components of a solid agreement — and where the potential traps lie:

Triggering event – Typically, the triggering event for a buy-sell agreement is death or disability. But it could also be divorce, bankruptcy or simply a desire to retire or sell the owner's interest to a third party.

Trap: Not considering other potential triggers, such as an owner being indicted or convicted of a crime, losing a key license or accreditation, or even losing residency status.

Solution: Address all potential triggers — and define them clearly. For example, if "disability" is a trigger, include the actual definition and determination of disability.

Valuation mechanism – Once a buyout is triggered, a fair price must be determined. Likewise, establishing a valuation of a deceased owner's interest in the business may also be necessary for estate tax purposes.

Trap: Failure to agree beforehand on a valuation method. Once a share buyout is triggered, ugly arguments of "my appraiser" vs. "your appraiser" can arise.

Solution: Spell out an equitable way of estimating the value of the business. Some closely held businesses agree to bring in independent appraisers on both the buy and sell side and split the difference. Others agree to reassess the business on an annual basis and use that figure for the next 12 months.

Likewise, contentious issues surrounding valuation can arise with the surviving spouse of a deceased shareholder, who may never have communicated the details of the buy-sell arrangement. A possible solution for diffusing the potential of a deceased shareholder's spouse later questioning the process of determining value is to have the buy-sell agreement signed by both the shareholder and the shareholder's spouse.

Funding source – Typically, life insurance is used to fund the buyout of the departing owner's interest, such as with a cross purchase agreement.

Trap: A $750,000 life insurance policy purchased years ago to fund an eventual buyout may come nowhere near the estimated value of a deceased partner's share of a thriving professional practice that has grown exponentially since its inception.

Solution: Once completed, a buy-sell agreement should be reviewed regularly (preferably annually). Of course, it should always be reviewed in the event of an ownership change, substantial purchase of equipment, real estate purchase/sale, and any change in the form of practice entity (incorporation, etc.).

To further minimize the cash flow disruption of the purchase, consider establishing a schedule of payments over time, rather than a lump sum payout.

BUY-SELL AGREEMENTS:
The Ticking Time Bomb of Succession Planning, Cont'd.

Also, consider discounts to the payout amounts for such things as lack of marketability and control.

Business continuity – Special concerns that should be addressed in any buy-sell agreement include a plan for business success after the loss of an owner/shareholder.

Trap: Important addendums are often overlooked when drafting a buy-sell agreement. For example, without a non-compete clause, a family member is free to take the buyout and start his or her own business in competition with the family business.

Solution: Include relevant restrictions in the buy-sell terms — non-compete/non-solicitation agreements, assignment of intellectual property rights, assignment of loan guarantees, even a clause providing for the termination of the buy-sell agreement itself, if necessary.

Much can change in a business over the course of time. A business that doesn't modify its buy-sell agreement to reflect these changes may be headed for financial or legal trouble down the road.

Structuring a solid buy-sell agreement is a team effort. We urge you to contact our office for assistance.

Valuation Methods: Which Standard?

- Fair Market Value – The most universally accepted definition of value, which tends to favor the company.
- Fair Value – Avoids penalizing a departing shareholder.
- Investment Value – Replicates a hypothetical insider transaction.
- Market Value – Replicates sale of the business to a motivated third-party buyer.

Where to Find Benchmarking Data

There is no shortage of companies producing benchmarking scorecards, surveys and the like. Problem is, the data tends to be pricey — often running into the hundreds, if not thousands, of dollars. Consider these sources for obtaining relevant data for benchmarking your firm's performance:

Vendors – Vendors of time-billing-accounting (TBA) software can compile similar accounting data from other firms and provide you with comparisons of how your firm ranks against them. This will allow you to evaluate profits per partner, billing turnover rates and other important financial benchmarks.

Bookkeepers – Think through the data you'd like to have on hand —monthly aged work-in-process, aged receivables, and billing realization and collection realization reports, for example. Then bring in a software professional to create tailored monthly reports that your bookkeeper can easily produce.

Uncle Sam – The Internal Revenue Service Corporate Sourcebook offers summary balance sheet and income statement numbers for all industries (including the legal profession), broken down by size of company or firm.

The ABA – The American Bar Association's website (http://american bar.org) contains a comprehensive section of data covering attorney demographics and distribution, as well as salary, career and retention surveys.

The National Association of Legal Assistants – NALA has produced a National Utilization/Compensation Survey (http://nala.org/survey.aspx) every two years since 1986. This in-depth report includes paralegal billing rates and compensation data.

Local bar associations – Check to see if your local bar association compiles its own benchmarking data, or if it can purchase an expensive survey that can be shared with members.

CPAs – Your CPA may have access.

For more information, please contact **Mike Prost, CPA/ABV/CFF, CVA, ASA** at 314.862.2070 or mprost@muellerprost.com.