THE TRIAL LAWYER'S GUIDE

Attorney's Dilemma-Obtaining Proper Fee From Structured Settlement

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Ann and Millard Johnson retained counsel as a result of a motor vehicle accident which left their 11-year-old son, Steven, comatose. The Johnsons and their attorneys entered into a standard retainer agreement, which provided in relevant part: "Attorney(s) shall be paid *33Y37o* of any money recovered in this matter. ..." Suit was filed on behalf of the Johnsons and six days prior to trial a settlement was reached. The settlement agreement provided for an immediate lump-sum payment of $600,000, out of which $500,000 was to be applied for counsel fees, and for the purchase by the defendants of a lifetime annuity on behalf of the minor with the following provisions :

(1) monthly payments equaling $23,000 per year for the life of the minor to be increased by three (3 %) percent per annum;
(2) payments under the annuity to continue for a guar- anteed period of 20 years; and
(3) the annuity to be insured by a company acceptable to plaintiffs.

Soon after the settlement agreement was signed, the Johnsons discharged their attorneys and petitioned the court through new counsel to modify the agreement, claiming that their former attorneys used an improper method to determine the value of the settlement on which to base their fees. The petition was eventually granted and counsel was informed that the Superior Court of Pennsylvania held that their fee of $500,000 was excessive.

This fact pattern is from the case of Johnson v. Sears, Roebuck & Co., 436 A2d 675 (Pa 1981). It illustrates several problems facing counsel in cases involving structured settlements, (1) drafting a proper retainer agreement; (2) choosing a method of calculating the value of the settlement as a basis for determining counsel fees whether paid "up front" or over a period of time; and (3) avoiding successful challenge by the plaintiff of the retainer agreement in court. This article will introduce the reader to the concept of the structured settlement and provide guidance to the practicing attorney on how best to resolve these problems.

A structured settlement is one where there is more than one payment to the plaintiff. Such settlements often combine several future periodic payments combined with an immediate lump-sum payment of cash. The periodic payments are usually arranged through either an annuity or a trust purchased by the defendant. In a trust-type settlement, the defendant invests in bonds with the proceeds used to make future payments to the plaintiff. In an annuity-type settlement, the defendant makes a single payment to a life insurance company which promises to make the periodic payments. With either type of settlement, the principal features are (1) that in lieu of plaintiff receiving a lump sum and investing it himself, monies are invested by the defendant without "constructive receipt" by the plaintiff, and (2) the plaintiff receives periodic payments whose timing and magnitude are agreed upon at time of settlement. Recently, use of the structured settlement has grown significantly due to a number of important benefits to both plaintiffs and defendants.

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The primary benefit to a plaintiff from using a structured settlement is the avoidance of federal income taxes on interest earned from the investment. Section 104 of the Internal Revenue Code excludes from gross income "the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness." This provision has historically been interpreted to exclude lump-sum awards or settlements from federal taxes. However, in Revenue Ruing 65-29, the IRS held that when the taxpayer actually received the present value of an award for personal injury and invested it, any interest earned on the amount invested is taxable. Conversely, the IRS has also held that as long as the plaintiff does not have actual or constructive receipt of the lump sum that was invested to yield the periodic payments, the interest is excludable from taxable incomes (see Revenue Ruling 79-220). These rulings have recently been codified into federal law, effective in the 1982 tax year and beyond (see Pub Law 97- 473). The significance of the trust and annuity-type settlements, discussed above, is that when used, the taxpayer does not obtain actual or constructive receipt of the award. Consequently, interest earned from investing the award is tax-free. The tax savings to the claimant can be truly substantial, particularly if his income approaches the maximum fifty percent (50%) tax bracket.

Other benefits accrue to plaintiffs as well. For example, a structured settlement may provide plaintiff and his family a guaranteed source of income for the life of the plaintiff or even longer. It can also assist plaintiff in budgeting his money. A structured settlement can assure that the award will be available to a minor after the minor reaches maturity. It can be counterproductive and detrimental to a child's welfare to hand him or her a substantial sum upon reaching maturity, which in many states is only 18 years. The automatic money management which is part and parcel of structured settlements in many instances is more significant than the tax advantage.

Structured settlements also benefit defendants. They can tailor the structured settlement so as to bring about an attractive package for the claimant, because they can buy annuities and the deferred payments are tax free to the plaintiffs. One often reads newspaper articles that a defendant as agreed to make periodic payments to a plaintiff for the life of the plaintiff, the sum of which is expected to exceed several million dollars. To the uninitiated it would seem that the defendant has paid out several million dollars; however, the defendant has, in fact, probably paid less than one-fourth to one-fifth of this amount. The remaining three-fourths to four-fifths is derived from large cumulative interest on the amount invested by defendant or an insurance company.

These benefits to plaintiffs and defendants have caused a dramatic increase in the use of the structured settlement. Business Insurance Magazine (July 20, 1981), for example, reported that the value of annuities used to fund periodic payment of settlements was expected to reach $500 million in 1981 as compared with $250 million in 1980 and $30 million in 1979. This phenomenal growth is expected to continue as structured settlements receive wider exposure and growing acceptance.

DRAFTING THE RETAINER AGREEMENT

As can be seen from the Johnson case, a standard contingent fee contract, providing that the attorney shall be paid a percentage of "any money recovered," is too ambiguous where a structured settlement is utilized. This ambiguity can cause problems for plaintiffs' attorneys. Several courts have held that where such conventional contracts are used, the attorneys may not be paid their full fees "up front."

This was the ruling in Cardenas v. Ramsey County, 322 NW2d 191 (1982). In Cardenas, the attorney and his client entered into a standard contingent fee contract which provided that the fee was to be one-third "of the total amount re- covered." The parties did not contemplate the possibility of obtaining a structured settlement when they entered into the agreement. A structured settlement was eventually obtained which provided for an up-front cash payment of $45,000 and further periodic payments totaling $110,800 over 10 years. Counsel took the position that his client had "recovered" $155,800 because the amount to be received under the settlement was fixed and because his services had been completed.

The client insisted, however, that "recovery" meant "received" and that he had thus far recovered only the up-front cash.

Concluding that the contract became ambiguous when the structured settlement was entered into, the Court proceeded to construe the contract. It held that under the circumstances, the client's view must prevail:

> ...when an attorney and client have entered a contingent fee contract under which the attorney is entitled to a third "of the total amount recovered" and the attorney thereafter negotiates a structured settlement of the client's claim without reaching an explicit agreement with the client governing the time and manner of payment of his fees, either put into writing or read into the record when the settlement is placed on record before the trial court, then as a matter of law the word "recovered" in the contingent fee contract must be construed to mean "received," with the consequence that the attorney is entitled to one-third of each payment his client receives under- the structured settlement as and when he receives it. Id. at 193.

The Court stated that this result was necessary because of the attorney's greater knowledge and experience and because of the trust placed in him by the client. Further, the Court explained that the policy expressed in EC 2-19 of the Code of Professional Responsibility "mandated this construction of the contingent fee contract."

A similar decision was reached in at least one other case. In Sayble v. Feinman, 76 Cal App 3d 509, 142 Cal Rptr 895 (1978), the parties entered into a contingent fee agreement which provided that the attorney was entitled to "281/3 % of any money recovered." As in Cardenas, the parties had originally contemplated that a lump-sum payment rather than an annuity would be obtained. The Court ruled that under these circumstances, the words of the contract were to be understood in their "ordinary and popular sense." The ordinary and popular

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.In the Comments of the Editorial Staff following this article, Joseph A. Bosco points out that periodic payments to attorneys need not be based exclusively upon the periodic payments to the plaintiff. However, Mr. Bosco agrees with Dr. Staller and Mr. Fineman in regard to the preparation of contracts of employment which contemplate the possibility of structured settlements. A stitch in time saves nine. It is suggested that attorneys pre- pare such contingent fee agreements in the alternative. In regard to structured settlements, the agreement may provide for periodic payments of fees to the plaintiff's attorney over a specified period of time, or that he be paid in full "up front" based on the present value or cost of the annuity. Deter- mining the actual cost to the defendant or its insurer may be impossible. The defendant or its insurer may refuse to provide such information, al- though we can see no reason why. There is no "constructive receipt" by the plaintiff merely because he and his counsel are advised as to the actual cost of an annuity purchased by the defendant's insurer. In any event, it is relatively easy to determine the approximate cost simply by consulting brokers and disclosing to them the terms of the proposed annuity. In the event the defendant's insurer purchases United States treasury bonds in connection with a structured settlement (which bonds are not owned by the plaintiff, but the interest is paid to him until maturity and the principal paid to him at maturity), the determination of the cost of the bonds is a simple matter.

meaning of the term "money," the Court concluded, was "cash proceeds." The Court held that because the client would not, in fact, recover any cash proceeds until she actually received each annuity payment, the attorney was entitled to a percentage of each payment as and when received by the client, and not before. The Court implied that had the retainer used language such as 28l/3 percent of "the recovery," or the "full recovery," or "the value of the entire recovery," or "the amount realized," the outcome might have been different.

Thus, by using a standard contingent fee agreement the attorney may have to take his percentage fee from each periodic payment as and when received. Although this mode of payment would eliminate the need to reduce the sum of the periodic payments to its "present value," a particularly difficult problem discussed below, it has one obvious drawback: the attorney will have to wait the entire duration of the settlement period to obtain his entire fee. This prospect poses significant problems in firm management, i.e., cash flow, prospective mergers, dissolutions, etc..

To avoid these problems the attorney should anticipate the use of a structured settlement in all cases where such settlements are at all foreseeable. The fee agreement may, but need not, provide that in the event of a structured settlement that the attorney's fee is to be a percentage of the sum of the up-front monies and the same percentage of the present value or cost of the periodic payments which are to be made to .the plaintiff. The fee agreement may also provide an option whereby the attorney could receive the fee on a deferred basis. This latter provision allows the attorney to structure the timing of the receipt of his fees. An example of a proposed fee agreement is included as Appendix A.

METHODS OF CALCULATING THE VALUE OF THE SETTLEMENT

In any type of settlement where the attorney is entitled to immediate payment of his fee, the value of the settlement must be calculated in order that the fee can be determined. When a settlement calls for a single cash payment, there is no difficulty in determining the settlement's value-it is the amount of the cash payment. However, where a structured settlement is used, determining the cost or present value of the settlement can present problems because the amount invested by the defendant (or its insurer) will be much less than the amount plaintiff will eventually receive over time. Another method of ascertaining probable cost is to ascertain the probable "present value" of the aggregate of the future payments. Two principal methods of calculating present value have been utilized by the courts and are generally accepted by the insurance and financial communities.

One method of calculating present value is by reducing the stream of future payments to "total actual cost." The "total actual cost" of the future payments is the actual cost in today's marketplace to generate a similar stream of future payments. For any given payment stream, the "total actual cost" depends upon the rate of return on investments. The higher the rate of return, the lower the "total actual cost" of a fixed payment stream, and vice versa.

The second method of calculating the present value of a structured settlement is by reducing the future payments to a "total expected present value." This is performed by determining the stream of all future payments and discounting the stream by the anticipated rate of return.

Because structured settlements have only recently become popular, very little litigation has taken place regarding which of these methods for determining present value is appropriate. To date, only two jurisdictions, New Jersey and Pennsylvania, have directly addressed this issue. Both require use of the "total actual cost" method.

The leading New Jersey case is Merendino v. *FMC* Corp., 181 NJ Super 503, 438 A2d 365 (1981). In Merendino, a products liability-wrongful death action, the widow and child of the deceased received a structured settlement providing the following:

1) a $210,000 cash up-front payment to the widow;
2) guaranteed annual payments to the widow totaling $654,424 over 25 years and
3) guaranteed payments to the daughter totaling $72,000 over 11 years.

Plaintiff's counsel retained an expert to determine the present value of the settlement. The expert's opinion was that the "value of the settlement could be conservatively stated as $472,722," calculated as follows:

Cash	210,000
Value of the widow's payments discounted by an 8.5% net rate of return	$225,984
Value of the daughter's payments discounted by the same factor	$ 36,738
	TOTAL $472,722

However, the record showed that the total *actual* cost of the settlement was as follows:

Cash	$210,000
Cost of widow's payments	$159,938
Cost of daughter's payments	$ 29,622
	399,600

In determining which total represented the present value of the settlement from which the attorney's fee should be calculated, the Court chose the latter. The principal reason was that the higher total, arrived at by using the total expected present value method, assumed only an 8.5% average rate of return. The difficulty is that the actual rate of return during the period for which the payments were to be made may be greater than the assumed rate of return. Consequently, the present value of the settlement may in fact be much smaller than anticipated. Accordingly, the attorney's fee may be over- stated.

Instead, the Court stated that the "marketplace cost [total actual cost] is the acid test in a case like this" because it did not involve "calculations of value that involve interest rates estimates for the future." The Court explained that the "cost of the annuities" more accurately reflected the present value of the settlement. Merendino has been followed in the three subsequent New Jersey cases addressing this issue. See Donaghy v. Napolean, 543 F Supp 112 (D NJ, 1982) ; Landgraf v. Glasser, 186 NJ Super 381 (1982); Tobias v. Autore, 182 NJ Super 328, 440 A2d 1171 (1982).

In Johnson v. Sears, Roebuck & Co., supra, plaintiff's counsel, using the total expected value method, calculated the present value of the settlement as follows:

Cash	$600,000
Value of the periodic payments	$1,050,422
TOTAL	$1,650,422

The sum of the future payments was calculated by multiplying each payment ($23,000 per annum with a three percent (3%) yearly increment) by the anticipated life expectancy of the minor (50 years as computed by an actuary and based on Standard Life Expectancy Tables). This resulted in a total of $2,594,170. This amount was then reduced to $1,050,422 by applying a discount factor of only 6% simple, which allegedly represented the anticipated average]~ate of return during the minor's 50-year life expectancy. court to interpret a contingent fee agreement in such a manner as to not allow counsel to receive his fee from periodic payments received as a result of a successful lawsuit against an insurance company on an insurance policy. These cases have involved health and accident insurance policies and/or disability insurance policies. However, they are indicative of problems that a practitioner can have with an ambiguous fee agreement. See Stoebe v. Kitley, 249 NW2d 667 (Iowa 1977); Blazek v. North American Life & Casualty Co., 121 NW2d 339 (1963).

Defense counsel and claims executives must also be aware of the problems which can arise later if they participate in negotiations with plaintiffs' attorneys in regard to payment "up front" of the full amount of fees.. Certainly, if plaintiff's counsel believes that he is not adequately compensated for his work, a structured settlement will be difficult if not impossible to negotiate. A solution is found in Uberetus v. Philadelphia Transp. Co., 8 Phila 124 (1983), in which the Court found that periodic payments of fees provided for by the structured settlement was an acceptable method of paying the plaintiff's attorney.

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* In the Comments of the Editorial Staff it is suggested that defense attorneys and claims executives negotiate only in regards to when and how much is to be paid *to plaintiff* and not discuss *at all* the matter of plain- tiffs' fees. Of course, by offering a large amount up front, there is a tacit recognition that plaintiff's attorney may be paid his full fee immediately from such payment. But the point is that there should be no direct discussion or correspondence in regard to fees.

Even if the contract of employment does not contemplate a structured settlement, the structured settlement may provide for payment of attorneys' fees over a specified period, such as five, ten or more years. If, for example, an annuity provides for payments to a plaintiff over a period of 50 years, which, if he lives 50 years, will aggregate $6,000,000, the actual cost of the annuity, that is the amount paid by the defendant's insurer for the annuity, may be $800,000. Assume the plaintiff's attorney was employed on a contingent basis of 25"/", so that his fees should be $200,000. The structured settlement could provide for periodic payments to the plaintiff's attorney over a period of 10 years (or some shorter or longer period), based on the "present value" of the $200,000 and what that amount should produce in principal and interest over the designated period, employing a fair interest rate (would/could be that used in the annuity itself).

APPENDIX A

REPRESENTATION AGREEMENT

, hereby names, constitutes and appoints the above attorneys to represent in the handling, presentation and settlement of any and all claims which client may have as a result of the above described legal matter and to institute any and all litigation necessary in connection therewith, and to supervise and generally handle the same and does hereby agree to pay the legal fee in the amount of thirty-three and one-third percent (33¥s %) of the gross recovery, if recovered in a single cash payment, whether as a result of settlement or trial.

In the event a structured settlement is entered into providing for deferred periodic payments. as to client's claim, the structured settlement may also provide for periodic payments of fees to the attorneys over such period of time as the periodic payments are made to the client, or at the option of the attorneys, the payments may be paid over a period of
years. The fees of the attorneys shall be based upon the actual cost of such negotiated structured settlement, to the extent the actual cost is ascertainable.

Client understands that attorneys will investigate client's claim, and if at any time thereafter it does not appear to have merit, then attorneys shall have the right to terminate this agreement.

It is further understood and agreed that client shall pay, upon execution hereof, initial expenses and all out-of-pocket costs involved in the prosecution of this claim, such as court costs, costs of litigation, expert witnesses, depositions, and the like, and will be in addition to the legal fees set forth above. In the event such costs are not paid by the client, the attorney shall advance such costs and expenses which are to be reimbursed at the conclusion of the litigation.

All medical expenses and medical charges of any kind in regard to the claim are not litigation costs and will be paid by client. In the event of a recovery, client agrees that attorneys may pay any of these bills from client's share of the recovery. Should client recover nothing, it is understood that attorneys are not bound to pay any of these medical bills.

If no recovery is obtained, no fee shall be payable to the attorneys. The attorneys, in their discretion, may withdraw at any time from the case if investigation discloses no insurance coverage or no assets or no liability of the defendant. Associate counsel may be employed at the discretion and expense of the attorneys.

Client hereby authorizes the attorneys to turn over all in- formation including doctors' reports, et cetera, and any and all pictures to the insurance company of the defendants.
No promise or representation has been made by said attorneys. as to the outcome of the claim or litigation, or as to what amounts, if any, client may be entitled to recover in this case.
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Attorneys Client

.Compensation may be successfully deferred by agreements between an employer and employee or between two independent contractors. Rev Rule 60-31, CB 1960-1, p 174. See IRC (1954), Sec 404(d). While the word "employee" is used generally in this discussion of deferred compensation agreements and their taxation, what is said is equally applicable to independent contractors.