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Focus

Value of Settlement Cash Can Be Increased in Various Ways

By Jeffrey Krivis

When Congress decided to include, as gross income, settlements made for "non-physical" injury torts, it reduced the value of such settlements by up to 45 percent. This has been particularly devastating in employment cases where emotional-distress recoveries often helped the employee transition into a new employment situation. Now that those recoveries are taxable, it has been difficult for practitioners to find ways to create more value out of a settlement, aside from getting the defendant to pay more money.

Several ways exist to create more value to the employee when dealing with limited settlement dollars:

■ **Structured settlement.** Perhaps the least utilized but most potent source of assistance to the employee is the structured settlement. This is basically an annuity that is purchased by the employer and designed to pay the employee over the course of months or years a certain sum. That sum grows depending upon the length of the annuity.

The employee may pay fewer taxes on periodic payments, as opposed to the taxes that he or she would owe on a lump-sum settlement.

The primary value in this approach is that the employee defers taxes on the settlement funds until they are actually received as opposed to the year that the settlement takes place.

Before the employee receives the money, arrangements are made with a structured-settlement broker, who shops the life-insurance market in order to retain an annuity company to purchase an insurance product from a highly rated insurer.

Several companies now will allow a non-qualified assignment of ownership of the annuity. This means that the employer no longer has to own the annuity but simply has to pay the money to an insurance company, which then will make periodic payments to the plaintiff based on the amount of the settlement.

According to Jim Brady of Ringler Associates, the value to the employee is that "they have the security of a guaranteed stream of payments backed by an annuity from a highly rated life insurance company."

The employee may pay fewer taxes on periodic payments, as opposed to the taxes that he or she would owe on a lump-sum settlement. The rate of return is secured and no management fees are involved.

By way of example, if an employee, who alleged sex discrimination in the workplace, settled a case for $100,000, the numbers would be something like the following: Attorney fees at 40 percent would equal $40,000; federal income tax at 27 percent would equal $27,000; the net to the plaintiff would be $33,000.

If part of the settlement were structured over a 10-year period, then the tax to the employee would be $15,000, which is based upon 15 percent of the value of the total settlement over 10 years. The plaintiff would pay tax only based upon the amount that he or she received each year.

Because the plaintiff's taxable income likely would be significantly more during the year that the settlement was reached, by spreading that out over a period of time the tax rate also is reduced because the income is significantly less. The employee would realize approximately 45 percent of the settlement, or $45,000. The employee defers the income tax at a lower rate while creating a secure stream of income that assists with other financial needs.

The considerations that would justify a structured settlement include whether the employee:

■ Actually needs the cash up front or can afford to defer income.

■ Might be interested in a retirement-type plan that can be set up at the time of the settlement.

■ Has any other future needs, such as a college fund, mortgage or other long-term commitment that would benefit from a periodic payment plan.

■ Has a "lottery ticket" mentality about the case.

■ Has counsel that can craft a physical-injury component.

■ Has long- and short-term goals that fit a structured settlement.

■ **Workers' compensation.** Since the landmark decision in *City of Moorpark v. Superior Court,* 18 Cal.4th 1143 (1988), many employees are concurrently filing workers' compensation claims while prosecuting discrimination actions. If the workers' compensation claim is still open at the time of the mediation, counsel should consider running a portion of the settlement funds through the Workers' Compensation Appeals Board.

Often, the employer's insurer will deny the claim automatically, yet the claim remains on the books. When finalizing the mediation in the civil action, the employee can negotiate a compromise and release of the workers' compensation claim using some of the funds provided in the civil action. Since workers' compensation settlements are tax free, the employee is able to maximize the settlement money in his or her pocket rather than give most of it to the government.

Some employers are skeptical of this approach because of the impact on their underwriting. Since workers' compensation premiums are currently out of control, employers tend to shy away from having to pay out on another claim. On the other hand, some employers don't mind a small amount of the settlement funds being diverted through the workers' compensation system in order to have that claim resolved for good.

■ **Stock options.** Losing a job often means more to a senior-level person than losing a mere bi-weekly paycheck. The person's focus while employed is primarily profit driven, so that not only will the company have success but the employee also will reap stock benefits. When this benefit is lost, it can cause an employee to feel as though his or her time with the company was wasted.

One easy way to encourage a former employee to fairly evaluate a case and negotiate a settlement is to offer stock options for an additional period of time past the employment. This allows the employee to control his or her own destiny as far as corporate profits are concerned.

■ **Outplacement services.** When employees are out of work based on an alleged discrimination or harassment issue, often they lack the focus or direction to jump back into the work force. This results in an emotional spiral downwards.

Many employers have relationships with outplacement service organizations that assist former employees in presenting a professional profile to prospective employers. Usually the cost of such services is between $2,000 and $5,000. When the employer pays for this as part of an overall settlement, it provides added value at minimal cost.

■ **Bodily injury release.** Some cases, such as sexual battery, are torts rooted in physical injury. As such, the law allows the physical injury to be viewed as a non-taxable event. Counsel can negotiate a bodily-injury-type release for a significant portion of the settlement in order to create a larger share of the proceeds for the employee.

■ **Consultancy agreement.** A consultancy agreement offers benefits to the employee and the employer. For example, an employer can utilize the strengths of a former employee in doing certain tasks while they are looking for a replacement employee. An employee has a transition income while seeking other employment.

Sometimes the parties simply enter into a consultancy agreement to defer some income or to allow the employee to represent to the rest of the world that he or she is still employed. It's much easier to get another job while working for someone than it is while unemployed.

■ **Cash now, part cash next year.** A simple way to avoid a huge tax liability in one year on money received from a settlement is to ask the employer to pay it over two calendar years. This doesn't mean over 24 months. If a settlement is concluded in September, then the first payment could be in October, while the second and final payment is in January of the next year. That way, the income-tax obligation is deferred a year.

■ **Court determines legal fees.** When the dispute turns on the amount of legal fees, counsel should consider reaching an agreement on the value of the case without attorney fees. Have the employee's counsel submit a motion in court to have the trial judge determine a fair amount for fees.

■ **Stock instead of cash.** By offering stock instead of or in addition to cash, an employer gets to retain cash flow without discounting the value of a case. Sometimes a combination of stock and cash will help seal a deal.

■ **Separate check for the lawyers.** It is always preferable to have the employer make separate settlement checks out to the lawyer and employee for their respective shares, along with separate Form 1099s.

■ **Letter of recommendation and/or apology.** If all else fails, there is always the tried and true letter of recommendation. If that fails, even a simple apology might make the difference.

Jeffrey Krivis teaches at Pepperdine Law School and is currently the president of the International Academy of Mediators. He has mediated more than 3,500 disputes.