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PRACTICE POINTS

“Recycled Annuities” a Bad Alternative for Funding a Structured Settlement

By Stephen R. Harris – December 18, 2018

Structured settlements are tax free payments that are paid over time and funded by highly regulated and rated insurance companies. The individual’s payment rights are funded by an annuity purchased pursuant to the individual’s settlement agreement.

Recently, settling claimants and their attorneys have encountered an alternative product for funding a structured settlement using a “recycled annuity” or “recycled payment stream,” which consists of a prior structured settlement payment stream purchased by a factoring company from an existing settlement plaintiff through a proceeding under the state’s Structured Settlement Protection Act (“SSPA”). The SSPA provides protections for individuals who seek to sell all or a portion of their structured settlement payment stream for a lump sum payment.

After obtaining a court order approving the purchase of an individual’s payment rights, the factoring company finalizes a separate contract with a different plaintiff to sell the individual’s payment rights; hence the term “recycled annuity.” The second plaintiff purchases the recycled payment stream from her lump sum settlement of her personal injury or workers compensation claim.

Not surprisingly, the amount paid by the second plaintiff for the recycled payment stream is much greater than what the factoring company paid to the original payee. The factoring company markets the recycled payment stream based on its apparently attractive yield. However, because the recycled payment stream is taxable and also fraught with risk, the deal is not as good as advertised.

Unlike the original structured settlement, where the entire amount of the periodic payments is excludable from the payee’s income under Section 104 of the Internal Revenue Code, the purchaser of the recycled payment stream used her lump sum payment (which is excludable from income) to purchase the payment stream. The settling plaintiff will be taxed on the difference between what she paid for the recycled payment stream and the total amount of payments received.

Because the plaintiff acquiring recycled payment rights has no direct relationship to the source of the recycled payment stream, the annuity, there could be serious legal consequences in the event of the insolvency of the factoring company. The plaintiff acquiring the recycled payment rights has no clear rights against the annuity issuer and therefore may have her only recourse against the factoring company.

Moreover, while structured settlement payments may be exempt from the claims of creditors in certain states, such exemptions are unlikely to apply to recycled payment rights. Further, in the unlikely event of an annuity issuer’s insolvency, recycled payment streams will probably not receive the protection afforded periodic payments by state guaranty association coverage.

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Similarly, should the purchaser of a recycled payment stream seek to sell her recycled payment stream rights, she would not receive the protection of the SSPA offered the original payee receiving tax-free periodic payments, such as the right to review disclosures (including information on the discount rate being charged) and the accompanying court approval. Since the SSPAs apply to transfer of payees' rights under the original structured settlement annuity, the purchaser of the recycled payment stream would not receive these consumer protections and would be at the mercy of the often unscrupulous factoring industry.

Of what should be of even greater concern to the purchaser of a recycled payment stream is the growing number of cases in which the underlying plaintiff who sells his annuity payments seeks to have the sale vacated on the grounds that he lacked authority to sell or that the court lacked jurisdiction over the transfer.

There are several cases currently pending where, despite court orders authorizing the transfers, the payee now seeks to have the orders vacated on the basis of factoring company fraud. In several such cases, the payees allege that they were not residents of the states where the transfers took place, and now seek to void the transfer orders. A pending putative class action seeks a constructive trust on all past and future payments received by factoring companies and their assignees on hundreds of transfers which occurred over many years in Portsmouth, Virginia, primarily bared on the allegation that the factoring companies violated the SSPA by not advising payees of their right to independent legal or financial counsel in connection with the transfers.

There have also been several instances where approval orders were forged, once by an employee of a New York law firm representing factoring companies, and then by an attorney who represented factoring companies in Florida. In the latter case, over 100 approval orders were forged. Although almost all of these transfers were later reconfirmed by the court, the assignees of the factoring companies ran the risk of losing their investments.

Recently, the United States Court of Appeals for the Third Circuit ruled against the buyers of a recycled payment stream on their breach of contract claim against the seller, after the state court voided the original transfer under the SSPA based on fraud and ordered that the annuity issuer redirect payments to the attorney for the original payee. Although, the Court allowed the buyers' claim for unjust enrichment against the seller to proceed, the opinion further underscores the potential peril facing buyers of recycled payment streams.

Recycled payment streams are clearly not a suitable replacement for traditional structured settlements. When considering a structured settlement, brokers, attorneys, judges, and settlement claimants are best served by a structure which is tax free and funded by a highly regulated and rated insurance company.

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