FINANCIAL ADVISOR

An Undiscovered Asset Class

By Bruce W. Fraser
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Most advisors know little about the structured settlements market.

Structured settlements have more twists and turns than a Dashiell Hammett novel—which perhaps is why so few financial advisors have made much use of them to date. Yet the dollar amounts in settlements can range into the millions of dollars, thus making them a potentially profitable niche market for wealth managers and other fee-only advisors.

How so? Well, consider this: The National Structured Settlements Trade Association (HYPERLINK "http://www.nssta" www.nssta.com), with only 650 settlement company members, far fewer than needed, pegs the total amount of tort settlements and judgments in the U.S. in excess of $200 billion annually. Of that amount, it's estimated that the structured market portion represents $75 billion to $100 billion or so—a figure that's climbing steadily. However, the structured settlements industry in 2005 only captured approximately $7 billion of this potential market, according to Stan Harlan, president of Summit Settlement Services in Clive, Iowa.

So, potentially the structured settlement market today is huge, and therefore at least tangentially relevant to advisors. To understand how your clients might benefit, you first have to understand what a settlement is, and how they are best adopted and under what circumstances. Finally, you need to know how best to tap into this honey pot.

In essence, a structured settlement is an alternative to a lump sum, or all-cash, payment. It's best described as a stream of tax-free periodic payments usually funded through the purchase of a single-premium annuity. Most settlements today are derived from personal physical injury lawsuits, but can also involve lawsuits from wrongful death, medical malpractice, claims by minors and incapacitated adults and other forms of litigation. In short, a structured settlement is another investment option available to the recipient of a claim with certain benefits few other financial products possess—namely, "triple tax-free" income, guaranteed payout, spendthrift protection inflation protection and very low risk of loss.

"In any personal injury settlement, a structured settlement should always be one component of the injured party's investment portfolio," says Charles Bradford, president of Bradford Settlement Co. in Atlanta.

When a structured settlement relates to wrongful death or personal physical injury, assuming the structure is properly set up, the benefits received are free of income tax by virtue of provisions in the Internal Revenue Code. Their tax-free status is one of their chief advantages.

"They're not for everybody, but the tremendous tax advantages of a structured settlement annuity should be weighed against other methods of investing lump sums," says Brian Puckett, a wealth manager in Oklahoma City, Okla., who has used structured settlements with clients. "As an added bonus, it can really prevent somebody from squandering the money rather than investing it, because they'll only receive the money monthly or annually."

Matthew Grimmer, general counsel for PASS Consultants LLC, a structured settlement firm in Austin, Texas, and one of only a handful of tax attorneys who specialize in structured settlement law, also cites the tax advantages: "Rarely does a person have the opportunity to invest money without paying taxes on the gains, and have the control to design the withdrawal and access to such funds according to the individual's life and anticipated needs as opposed to a government-mandated withdrawal date."

To illustrate, Puckett recently helped put a client considering various investment options into an annuity with a purchase price of $150,000. A structured settlement annuity was funded that generates $983 per month for the balance of the client's life, with payment guaranteed for 20 years. The annuity was structured to pay out at least a total of $235,920 to the client or his heirs during the 20-year guarantee period. Assuming the client lives out a normal life span (47.3 years for a 35-year-old male), he would receive $557,951 from the annuity—or more than 3.5 times the amount required to fund the annuity.

Importantly, all proceeds received are completely tax-free. "In the right circumstances, (a structured settlement) makes a lot of sense," Puckett says.

Typically, in such cases an attorney calls Puckett with a client who has been injured or had a spouse die and is considering settlement options. Often, of course, individuals elect to take the lump sum and buy a house, travel, invest in a business, or spend the money in another way. Mostly, they fritter it away, Puckett says.

Others, however, may prefer to invest for the long term. Such individuals are potential clients of Puckett and other financial advisors, who can assist the client to invest the proceeds from such claims in investments such as stocks and bonds, annuities and other instruments.

Safety is another big advantage of structured settlements cited by those who use them. You know you're likely to receive a payout regardless of how the stock or bond market performs.

Five years ago, attorney Grimmer put his mother-in-law in a structured settlement. When she was notified she was to receive a seven-figure settlement from her diet drug claim, she had to decide whether to take the money or defer receipt of the money through a structured settlement and allow it to grow tax-free. She decided to split the decision and take half in cash and put the other half in a structured settlement payout schedule (with a monthly payout in the five figures) that guaranteed 20 years of payments and would last at least the rest of her life.

Within six months of her decision, the stock market crashed and she lost nearly one-half the value of the cash she and her husband had invested in the market, Grimmer recounts. Not surprisingly, he says, she laments not putting it all in the structured settlement, with the added advantage of tax-free growth.

The structured settlement industry has existed since the early 1970s and has been encouraged by Congress since the early 1980s. The industry saw rapid growth in the late 1990s because of higher interest rates, and has seen steady growth since 2001.

“Our industry is capturing only 7% of the settlements market, so there’s obviously room to grow,” notes Bradford, who says there are not enough settlement people or financial planners today servicing the market, which is steadily burgeoning with larger and larger settlement figures.

The field provides fertile ground for advisors, as many persons who encounter sudden wealth—inheritors, athletes, claimants in lawsuits, for example—blow through it quickly, creating a vacuum for advisors to fill. Keith Singer, a wealth manager in Fort Lauderdale, Fla., says, “Many don’t understand the basic principles of money management and budgeting. Structuring a settlement doesn’t solve the problem; it makes it harder for plaintiffs to spend all the money.”

Advisors who understand the settlement process thus have a wide-open field in which to navigate. And the sums involved can be big. Anna M. Jones, a wealth manager in Houston, for example, has done structured settlements for clients in malpractice suits with claims ranging from $5 million to $20 million. In such instances, ones involving beneficiaries with severe enough injuries that medical costs can last a lifetime, structured settlements can provide a steady stream of income to match those rising expenses. Jones says she was never compensated on the sale of these products, but rather on a percentage of the assets managed outside of the structured settlements as approved by the court at the settlement hearings.

One reason advisors have been reluctant to participate in this market is because it is complex. Guardian-beneficiary relationships in cases involving minors are often complex and cumbersome to set up, as laws governing them vary state by state. Also, the average plaintiff tends not to be in a high tax bracket. Then, too, structured settlements are inflexible. “Once you have one, the only way to get the principle back is to sell it and you’re not going to get as much up front as you paid for it,” notes Singer.

In addition, few advisors are appointed by insurance companies to sell structured settlements. Most of those appointments go to full-time structured settlement specialists who do not offer financial planning services. Bradford sees an opportunity for financial advisors to associate themselves with firms such as his. Advisors attempting to access the market on their own will encounter a "Catch 22," as he describes it. "This is not a brokered life insurance product," explains Bradford. "Simply being properly licensed doesn't permit an advisor to obtain settlement quotes from the various life insurance companies that offer the product. You can only access the industry through a structured settlement brokerage firm."

Still, there are definite payoffs for those who venture into this realm. As with financial planning, the way advisors benefit from structured settlements is based on how they are paid. Advisors could receive a fee for helping the client manage part of the settlement that is not structured. Alternatively, an advisor could charge a client a fee for creating a financial plan or for helping him manage the cash flow created by the structured settlement.

Finally, advisors with insurance licenses potentially could receive commissions on the sale of structured settlements, in addition to fees and commissions for other financial services they provide.

One way to tap this underserved market is to network with trial lawyers the way you would with CPAs or estate planning attorneys. "Lots of structured settlement salespeople are networking with trial lawyers to get structured settlement business. However, most of them do not provide the plaintiffs with other financial services they desperately need," says Singer. "All trial lawyers know that their plaintiffs need financial advice and they're not getting it. The best trial lawyers do care about their clients and want them to be successful managing their money."

Another way for advisors to make use of structured settlements is to team up with a settlement specialist and continue to offer the financial services in which they have expertise. The specialist will be able to help an advisor sell structures in exchange for part of the commission. As the relationship develops, the structured settlement specialist may refer other financial service work back to the advisor.

"At PASS Consultants we limit our offering to structured settlements so we are always looking to 'team up' with financial advisors," says Mark Edwards, vice president. "Our goal is to offer the injured party a more well-rounded package of financial services, which is best accomplished by bringing a financial advisor to the table."

Bruce W. Fraser, a freelance financial writer in New York City, has written for many publications. Visit him at www.bwfraser.com/home. He can be reached at frasernyc@aol.com.