The use of qualified settlement funds at the end of a case

QSFs are useful to address conflicts of interest between multiple plaintiffs or attorneys in a case or to pay government liens

By David M. Higgins

A Qualified Settlement Fund ("QSF") is an account administered by a third party. Although administration can be by the defendant by solely opening a segregated account, plaintiffs generally do not want the defendant holding the settlement money longer than necessary. QSFs are used to avoid conflicts of interest for the attorneys in multiple-plaintiff cases, to provide interest earnings to plaintiffs while disputes are resolved, to avoid personal liability of attorneys for unpaid government liens, and to release and dismiss defendants while liens and other issues are resolved. For defendants of questionable solvency, QSFs also assure receipt of the settlement proceeds promptly while other issues are being resolved.

The account holds settlement or judgment proceeds. While it holds the proceeds, the parties resolve disputes about how to allocate the proceeds, including among battling attorneys. They also determine and pay any liens from the account. The account can last weeks, months, years or even decades in the case of asbestos and Agent Orange. Asbestos QSFs have already lasted since 1988 following bankruptcy of the asbestos manufacturers.

Wrongful-death cases

In some states the wrongful-death proceeds are governed by distribution schemes to prevent disputes. For example, some states distribute the proceeds in accordance with the laws for intestate succession. Other states use a formulaic approach that avoids disputes. In many states, either the heirs must prove the amount of their dependence on the decedent or demonstrate to the court other forms of entitlement, leading to disputes. The disputes can last a long time. A QSF can be used to hold those proceeds until the disputes are resolved.

In the meantime, the legal fees and costs can be paid from the fund and each heir can be separately represented in settling the disputes.

Class actions and multi-plaintiff cases

The most common use of QSFs is in cases with large numbers of plaintiffs, whether certified as a class or not. Product-liability cases, drug cases, sexual abuse cases are all common situations in which QSFs are used.

Channeling injunctions and future claimants

Qualified-settlement funds are formed to resolve and satisfy claims. One of the most difficult tasks in doing so is what to do with claims that have not been made at the time the QSF is established and funded. The problems are several: (1) such claims are unknown in amount, which makes payment of current claimants difficult to calculate; (2) such claims are unknown as to timing, particularly for conditions with a long latency period between exposure to the product and manifestation of the illness; and (3) the amount of money available to pay future claims is unknown when QSFs are to receive the proceeds of pending or future insurance litigation or future earnings of the debtor.

Section 524, subdivision (g) of the Bankruptcy Code appears to be limited to an asbestos claim, but courts have allowed other claims to be included, e.g., claims for lead exposure in *In re Eagle-Picher Indus*. (S.D. Oh, 1996) 203 B.R. 256. Even without section 524, subdivision (g), however, bankruptcy courts issue injunctions to channel future claims to a QSF using the court's power under section 105 of the Bankruptcy Code.

Attorneys' conflict of interest

When multiple plaintiffs exist in a case, the attorney can have a conflict of interest in allocating the settlement proceeds. The California ethics rules for aggregate settlements are codified in the Business and Professions Code. Remedies for their breach is generally fee forfeiture. Those rules require that, before agreeing to an aggregate settlement, every plaintiff must be told the amount of his or her settlement. In addition, if the amount of his or her settlement is different from the amount for other plaintiffs, then the plaintiff must be told why. Only after that process can a plaintiff's lawyer say yes to an amount offered by the defendant. Thus, QSFs can be important in assuring compliance with the ethics rules.

In large cases, that compliance does not necessarily require allocation to each plaintiff before the settlement amount is agreed to. Rather, the allocation process can be established using a third party. That process will normally include a grid classifying each injury into a category. Then, rather than making specific allocation in advance of agreeing to the settlement, the agreement of each plaintiff is solicited to the use of the grid

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and a third party to assign each plaintiff to the grid position. Then an appeal is offered for plaintiffs who disagree with their grid position. That process, in lieu of specific advance settlement allocations, satisfies the ethical rules.

Liens

If one or more parties has governmental liens, then personal liability attaches to the attorney for nonpayment of those liens if the attorneys hold the settlement proceeds in a trust account. Thus, determination and payment of liens is important. The QSF can do that, removing the risk to the attorney. In addition, the QSF can pay parties with no liens and pay parties as those liens are resolved.

A structured settlement

When a defendant or insurer refuses to enter into a structured settlement, the fund can be used to accomplish a structured settlement. The fund should not be used for this purpose if only a single plaintiff is present because annuity issuers will not issue an annuity where only a single plaintiff is present. There is no tax reason for not doing so, but the business practices in that industry have caused this result.

What causes of action qualify for a QSF?

You can use a QSF in all tort cases and environmental liability cases and discrimination cases. You cannot use a QSF in workers' compensation cases. Most commonly, QSFs are used in large class-action settlements. For example, when the defense and the plaintiffs' counsel have agreed on an amount to settle all claims in an aggregate amount, then the money is put into a QSF. At that point, the defendants get a release and dismissal and the QSF administrator starts the process of allocating the gross settlement amount among the plaintiffs.

The mechanics

The terms of the account are normally governed by a document that looks like a trust agreement, although QSFs are not trusts under local law because they lack grantors. The terms provide the source of the funds (the defendant or its insurer), how distributions are to be made, the duties of the fund administrator, and the disposition of settlement proceeds at the end of the fund. The last terms are important because large cases often end up with money at the end due to plaintiffs who could not be located, did not respond to mail or other reasons.

To establish the QSF, the parties file a petition with the court overseeing the litigation or the arbitrator conducting the arbitration and obtain an order approving the establishment of the QSF and retaining jurisdiction over the account. That jurisdiction is seldom exercised, however, and the QSF terms provide that the QSF terminates when the QSF has spent all of its money. If the parties are more comfortable with court supervision, then the QSF terms can provide that all distributions are subject to advance court approval, require periodic accountings, reports of investment performance and the other information traditionally required of a court-supervised trust.

The defendant's deduction for settling

In a multi-plaintiff case, the normal rule is that the defendant can deduct a settlement at that time the money is paid to a plaintiff. The QSF was added to the Internal Revenue Code to permit the defendant to deduct a payment in multi-plaintiff cases when the settlement is paid to the fund, rather than when the money is paid to each plaintiff. The same is true for the property-casualty insurer. That is, to obtain reserve relief, all that the insurer needs to do is pay the settlement amount to the fund, rather than to individual plaintiffs. The defendant or its insurer must file a form with the IRS reporting the transfer to the QSF and provide a copy of that form to the QSF administrator.

The QSF provision in the Internal Revenue Code is a deduction provision. Before the provision, the Congress had prohibited defendants from deducting structured settlements that would not be made until far into future years. The IRS thought that taking such deductions was a distortion of the defendant's income, and the government won some cases. But taking on deductions one by one was impractical. So, Congress enacted a prohibition against deducting any payment to settle a case until those payments were made to the plaintiff. That cut off defendants trying to accrue future structured payments before they were actually made. At the same time, however, it slowed mass-tort settlements because the allocation of an aggregate settlement can take years and the litigation would continue. The QSF provision permits the litigation to end when the aggregate settlement number has been agreed to and transferred to a QSF.

Regrettably, there are few tax lawyers for the defendant (or for the plaintiffs) involved in settlement negotiations. Thus, the benefit of using the QSF is often never noticed by the defendant or its insurers.

The bank for holding funds

Any bank can serve as a custodian. If the fund administrator provides a list of the claimants and their entitlement in dollars with the account-opening documents, then FDIC insurance is available on a per-claimant basis, rather than on the gross amount in the fund.

Releasing the defendants and its insurer

When the defendant or its insurer transfers the settlement proceeds to the fund, the plaintiffs provide a release to the defendant that dismisses the defendant from the litigation. The defendant and insurer do not need to wait until the settlement proceeds are paid to the plaintiffs in order to be released and be dismissed from the litigation. The court is required to retain jurisdiction over the fund until the fund terminates. Although the defendant has been released and dismissed, the docket number remains active. In most small- and medium-sized cases, such jurisdiction is never exercised. In large class-action cases, orders are sometimes obtained for distribu-

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tions and fees are approved under various class action theories.

Operation of the fund

The fund administrator will take instructions from the plaintiff's attorney in most cases. The attorney will notify the administrator when a distribution is ready to be made following allocations or the resolution of disputes. In large class actions, the administrator will decide, with court approval, when a distribution is appropriate.

The fund administrator will decide on investments or on a checking account for shorter cases with less money. The fund administrator will also file annual tax returns on Form 1120-SF reporting income earned and distributions made.

Investment of fund assets

While held by the fund, the account earns interest that can be paid to the parties at the end of the dispute. Amounts held in a client's trust account, of course, remit interest to the State Bar Association.

The tax rate on a fund is the highest rate in the Internal Revenue Code, with very limited deductions. Although the fund is sometimes invested in tax-free instruments, diversified portfolios can make sense for funds that last many years.

In addition to the tax motivation for tax-free investments, investment must be conservative, bearing in mind the time horizon for distributions, amount of damages likely to be paid to each present and future claimant and any unknown claimants. The problem of unknown claimants is particularly acute in some product cases. In asbestos, for example, the period between exposure and manifestation of disease can be many years. In some drug cases, future unborn claimants must be considered. Actuarial assumptions must sometimes be made to support current distributions when future distributions are hard to determine.

End of QSF life issue

In larger multi-plaintiff cases, the fund will often find itself with cash after all efforts to distribute the proceeds have been exhausted. For example, in the Boston Archdiocese cases, 20 years have passed. There is still a six-figure balance in the fund. Claimants do not want to go through the claim process because it brings up difficult memories. In the large drug cases, many claimants do not respond to mailings because they have moved with no forwarding address. Skip-tracing often does not result in valid addresses for those claimants.

The law provides that such extra cash can be distributed using the *cy pres* doctrine. That is, a charity can be located whose charitable purposes relate to the claim in the case in some way. With court approval, a distribution of the remaining cash is made to one or more such charities. Of course, later-arriving claimants are out of luck following those distributions, so every effort must be made to locate those claimants before making the charitable distributions.

In some very large cases, the amount remaining can support the creation of a charity to serve the needs of the remaining unpaid clients and also the needs of the aid claimants who have ongoing medical or other issues, such as the need for psychological counseling for PTSD claimants.

Using multiple funds in the same litigation

Where there is more than one class of plaintiffs, a QSF can be established for each class. The most recent example of multiple funds in the same litigation is the Flint water cases. When lead was discovered in the Flint water supply, thousands of individuals filed cases against multiple defendants and later consolidated. Under a settlement agreement, the amounts of the settlements were divided into a number of sub-qualified settlement funds. There were QSFs for minor children, minor adolescents, minor teens, future minors, property damage, business economic relief and others. Each plaintiff was assigned to a sub qualified settlement fund and within each sub qualified settlement fund, plaintiffs were paid the same amount.

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David's practice has, for 25 years, been limited to the tax and related issues that arise in the settlement of litigation. He is the administrator and tax counsel to the nation's largest qualified settlement funds and has distributed hundreds of millions of dollars to thousands of plaintiffs. More information about QSFS is at higginsqsf.com.

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