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Section 468B Settlement Funds: What They Are, and When and How to Use Them

by Dan Hindert, Esq.

Many judges, mediators and litigators don't yet have a working familiarity with Internal Revenue Code § 468B settlement funds ("468B Funds," "Section 468B Funds," or just "Funds"). These Funds are a settlement tool that is widely under-used due to lack of familiarity with what they are, and when and how to use them. The aim of this article is to help attorneys, ADR professionals and judges recognize when and how Section 468B Funds may be used to benefit all settling parties while promoting efficient use of attorney time and court time.

What Are Section 468B Funds?

Section 468B Funds exist as a temporary vehicle, or way station, in the handling of settlement proceeds: defendants obtain a binding release from liability by making a tax deductible payment into a court or government-approved Fund; claimants,¹ who have no tax consequence as a result of this payment into a Fund, can then take as much time as they need to sort out important issues of their own such as allocating settlement shares, resolving liens (which sometimes involve complex pay-back and set-aside issues as to Medicaid and Medicare), and deciding on a form of distribution that will best serve each claimant's unique needs (whether cash, or structured settlements, or special needs trusts to preserve eligibility for certain government benefits).

The procedure for creating and using a 468B Fund is as follows:

- Either litigating party petitions the court to order that a 468B Fund shall be established;
- The Fund is established and the court appoints an administrator to oversee it;
- Each settling defendant pays an agreed amount into the Fund and is then released from liability pursuant

to a settlement agreement which includes the Fund as a party and which must be approved by the court;

- With claimants' consent, the Fund assumes the liability of all settled claims, and its administrator then proceeds to settle in an individualized way with each claimant; and
- Subject to court approval, the Fund's proceeds are distributed pursuant to these individualized settlements, and the Fund is then dissolved.

Statutory and Regulatory Background

In 1986 Congress added the new § 468B to the Internal Revenue Code ("I.R.C.").² At that time, I.R.C. § 468B conferred two advantages on defendants and liability insurers when settling tort cases. First, the statute gave these taxpayers the certainty of being allowed a current tax deduction in the amount of their payment in a 468B Fund. Prior to enactment of I.R.C. § 468B, defendants and their liability insurers could not deduct the amount of a settlement payment until economic performance was deemed to have occurred.³ Second, the statute enabled these taxpayers to settle class actions and other large tort claims *before* class members' (or individual claimants') shares of an overall damage award had yet been determined. This allowed defendants to disengage from litigation, and to exit from the scene with a binding release in hand at an earlier juncture than would otherwise have been possible.

A 1988 amendment allowed the Treasury to develop regulations concerning the taxation of such funds,⁴ and in 1993 they defined a new type of 468B Fund called a "Qualified Settlement Fund (QSF)."⁵ While DSFs are used only for tort settlements, QSFs

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This article is based in part on material appearing in *Structured Settlements and Periodic Payment Judgments* (a treatise first published in 1986 and updated regularly through 2010) co-authored by Daniel W. Hindert, Joseph Julnes Dehner and Patrick J. Hindert, and is reprinted here with the permission of the copyright holder and publisher. That treatise is copyrighted by Incisive Media US Properties, LLC and published by Law Journal Press, a division of Incisive Media. All rights reserved. Copies of that complete work may be ordered at www.lawcatalog.com online.



may be used to resolve *any claim* “[a]rising out of a *tort, breach of contract, or violation of law.*” (emphasis added).⁶ Also, a DSF requires a court order, whereas a QSF qualifies for I.R.C. § 468B tax treatment if established or approved by and under the continuing jurisdiction of any federal or state agency.⁷ Fund administrators must ensure that documentation in each transaction complies with applicable tax rules.

When and Why Are 468B Funds Used?

The original impetus for Section 468B Funds was to help defendants and their liability insurers solve tax and related financial problems in settling large class action tort cases. In recent years, the use of 468B Funds has frequently been initiated by plaintiff’s counsel who recognize its value as a *settlement planning tool*. Good settlements require careful planning, and 468B Funds provide *breathing room* for claimant-specific settlement issues to be addressed as needed.

Often, adequate time for good settlement planning simply isn’t available because settlements occur very quickly in the pressure cooker of litigation. When an acceptable settlement is within grasp, the defense typically wants to terminate litigation and extinguish liability as quickly and efficiently as possible. Plaintiff’s counsel wants to get paid and needs to recoup costs. This introduces a tension, particularly in larger cases and those with *multiple claimants*, because these cases have a myriad of issues to be addressed before all claimant-specific terms of a settlement can be resolved and settlement funds disbursed. Section 468B Funds help all these stakeholders meet their respective needs.

There is an important, and still unresolved, tax issue whether 468B Funds may be used at all in cases involving a single claimant as opposed to multiple claimants or multiple occurrences. The underlying tax problem is that, with a single-claimant 468B Fund, that taxpayer may be deemed to have the economic benefit of proceeds as soon as they are transferred into the Fund. Until Congress or Treasury issues clear determinations or guidance, courts and counsel should be very cautious about approving or using 468B Funds in single-claimant cases. Some of the advocates for using single-claimant 468B Funds propose that lienholders (like Medicare or Medicaid) have their own separate and additional claims against the Fund, but there is likewise no tax authority for this position and it should be viewed cautiously by counsel and skeptically by courts when petitioned to approve a Fund involving a single plaintiff or claimant who sustained the legal harm giving rise to the claim or controversy.⁸

Section 468B Funds are useful because they provide a neutral space that simultaneously serves the needs of plaintiffs and defendants:

- *Efficient dispute resolution for a settling defendant*, who pays an agreed amount into the Fund in exchange for a clear and binding release with court approval; and

- A *safe harbor* for claimants who need breathing room to resolve their own important issues *before* any particular form of distribution is decided upon and *before* tax and other financial results are locked in place upon “receipt” of settlement proceeds.

Meanwhile, the establishing court (or governmental authority) retains supervisory control over the 468B Fund, but does not need to become involved in actual Fund administration.

What Are the Mechanics of Setting Up and Operating a 468B Fund?

The procedure for setting up and operating a Section 468B Fund is fairly straightforward. These Funds are established via motion practice which varies somewhat from jurisdiction to jurisdiction. Here is a typical example showing how counsel and/or the Fund administrator interact with a court and with settling parties in setting up, running and terminating (winding up) a 468B Fund. Procedurally, the following steps need to occur in some way, which may be separately or concurrently as appropriate.

1. Creating the 468B Fund.

- a. Plaintiffs, settling defendants, or some combination of these parties move the court for a discretionary order to approve establishing a 468B Fund, and to provide for a complete release of liability for each settling defendant (and its liability insurer) upon payment of an agreed amount into the Fund’s account.⁹




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b. Simultaneously, any litigating party moves the court to enter an order appointing an administrator for the 468B Fund, and to establish terms of the Fund's administration.¹⁰

c. The Fund administrator files a notice of acceptance of this appointment, submitting the Fund's administration to the jurisdiction of the establishing authority.

2. Administering the 468B Fund. Pursuant to the terms of the Fund's administration, the Fund's administrator does its business as follows:

a. The administrator moves the court (or governmental authority) to enter its order approving settlement by and among plaintiffs, the Fund and any settling defendant(s), dismissing them with prejudice.

b. Pursuant to court authorization, the administrator makes an initial distribution of attorney fees and costs to plaintiffs' counsel,¹¹ and of negotiated lien amounts to lienholders.

c. The administrator files a declaration of supporting materials which typically includes the following:

i. The Settlement Agreement, Assignment and Release of Claims by and among plaintiffs, the Fund and settling defendants;

ii. Confirmation that all liens identified by claimants and their counsel have been addressed; and

iii. The Settlement Agreements and Releases between the Fund and each claimant.

d. With court approval, the administrator then signs Settlement Agreements and Releases with all claimants.

e. The administrator moves for an order approving the distributions to all claimants and to any remaining lienholders, to certify the individualized Settlement Agreements and Releases, and to authorize disbursement of remaining settlement proceeds pursuant to those agreements.

3. Terminating the 468B Fund. When the Fund's business is over and all of its liabilities have been met, the Fund is wound up, remaining assets are distributed, and the Fund terminates.¹²

How Are 468B Funds "Supervised" by a Court?

There is no federal statutory or regulatory guidance on how to supervise a Section 468B Fund. Some United States district courts have local rules of civil procedure (typically under Rule 67) that refer incidentally to DSFs, QSFs or Section 468B Funds.¹³ Local rules under Rule 67 of the Federal Rules of Civil Procedure merely govern the deposit, receipt, and treatment of court registry funds, and do not provide actual guidance for supervising Section 468B Funds as they are used in regular practice (except to the very limited extent a court registry happens to be used for this

purpose, and in a jurisdiction having a rule of this type).

Over time, however, courts have gained practical experience in working with 468B Funds, and a growing body of case law shows judicial flexibility and practicality in doing so. Some of this case law is discussed below in the context of "practice pointers" for courts and for litigating attorneys.

1. Petitions to establish a 468B Fund.

Some plaintiffs have petitioned unilaterally to establish a Fund – over a defendant's objection – and have argued that they "have a right" to force the defendant to put settlement monies into a 468B Fund (reasoning that the defendant gets a complete release and so should not care whether its check is written to the 468B Fund or to the claimants directly). This idea was soundly rejected in a 2006 case, where the U.S. government agreed with plaintiffs on a cash amount to settle all claims but the parties did not reach agreement as to terms for structuring the settlement.¹⁴ Courts cannot create settlement agreements in the absence of party agreement.

Treasury regulations do not require that a 468B Fund be created in the same proceeding, by the same court, or even in the same state as the underlying claim or action.¹⁵ Regardless of whether a Fund's establishing and supervising authority is the same one that presided, or a different one that presided over the underlying claim, the judicial considerations that should apply when ruling on a petition to establish a 468B Fund remain the same. That is, where there is an objection to establishing a 468B Fund, the court should consider those objections and require the petitioning parties to show (i) that the benefits of establishing the Fund outweigh burdens imposed on the court in supervising it, and (ii) that defendants will not be prejudiced by using a 468B Fund to settle claims against them. Where there is no objection to establishing a 468B Fund, the court still has discretion to approve or deny doing so and should evaluate whether the benefits of establishing the Fund will outweigh burdens imposed on the court in supervising it.

2. Selection of a Fund administrator. A Fund administrator is in many respects like a Special Master. If the Fund administrator performs his or her duties competently and responsibly, the court's role in "supervising" a Fund is much easier. Here are some points to consider when petitioning a court to appoint a Fund administrator.

- **Who chooses the Fund administrator?** Responsibility for choosing a Fund administrator usually falls to the plaintiffs' attorney(s). Nothing in the federal statute or regulations specifies who may be a Fund administrator. Before counsel select or the court approves a Fund administrator, consider the range of duties this person will be charged with handling, and *appoint someone who is qualified to perform these tasks*. Selection and approval of a qualified person should not be taken lightly. Fund administrators have a number of duties that are inherently fiduciary in nature.

- **Duties that are fiduciary in nature** include complying in all respects with the order establishing the Fund and the terms of its administration. Upon receiving settlement funds (typically cash), the Fund administrator holds and invests the settlement funds; represents and protects the interests of all claimants against the Fund; and files and pays the Fund's liabilities including any tax liabilities.¹⁶ The parties may wish to choose and the court may prefer to appoint a fund administrator who is already held to fiduciary standards under applicable state law, for example, a corporate trustee. Where the parties choose and the court appoints a fund administrator who is not independently held to fiduciary standards under applicable law, it may be in claimants' and their counsels' interest to assure that a performance bond be posted.
 - **Investment and accounting duties.** Although not required, Fund administrators are well advised to use (and supervising courts to require) an independent corporate or banking entity to hold and invest all settlement proceeds. This is a simple way to provide regular (monthly) accounting statements that can be furnished as needed to the supervising court, and to all interested parties.
 - **Negotiating duties in allocating settlement shares.** The Fund administrator works directly with counsel for claimants (and with the claimants themselves, as needed) to allocate settlement shares. If there is a deadlock in allocating settlement shares, the administrator may use Fund proceeds to hire an independent mediator or even an arbitrator, if the terms of Fund administration so provide.
 - **Advising as to forms of distribution.** If a particular Fund administrator is competent to advise claimants (and their counsel) as to available forms of distribution that may be appropriate for them, he or she may certainly do so. If the Fund administrator lacks this skill set (or if claimants and their counsel prefer), claimants and their counsel may retain their own advisors for this purpose.¹⁷
- 3. Terms of Fund administration.** One of the court's key roles in supervising a 468B Fund is to review, before approving, the proposed terms of Fund administration. Here are a few practice points for courts and counsel to consider.
- **Restrictions on handling Fund proceeds.** As mentioned above, the order establishing the Fund should require that an independent corporate entity holds and invests all settlement proceeds. Also, the terms of Fund administration should define permissible investments.¹⁸
 - **Compensation of the Fund administrator.** The method of compensating a Fund administrator can give rise to conflicts of interest. For example, if, in addition to the administrator's other duties, he or she will serve as the broker for any structured settlement annuities purchased to fund periodic payments to

claimants, this gives rise to a conflict of interest when advising claimants as to the form of their distribution (i.e., structured settlement or no structured settlement). Likewise, this may also influence that administrator's judgment when negotiating with claimants and their counsel as to allocation of settlement shares (i.e., seeking to allocate more settlement proceeds to claimants who use a structured settlement rather than some other form of distribution). The potential for conflict is lessened (but not eliminated) if the administrator is compensated strictly on an hourly basis or some other basis not linked to commissions earned on sale of financial products.¹⁹

- **Subrogation and reimbursement claims.** The relationship between the 468B Fund and any liens and subrogation rights should be considered before a defendant pays monies into the Fund. In effect, a 468B Fund shifts the issue of lien resolution away from the contributing defendant who settles, and into control of the court. An instructive example of how lien rights intersect with 468B Funds is provided by the settlement of a complicated drug product liability class action.²⁰
- **Disagreement as to allocation of the settlement shares.** The terms of Fund administration should always provide how to resolve disputes among any claimants who cannot (voluntarily) reach agreement as to allocation of settlement shares. Some provision for mandatory arbitration is usually advisable.

4. Petition for distribution of Fund proceeds. Before approving distribution of proceeds from the Fund, the court needs to be assured by the Fund administrator that all liabilities of the Fund have

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been addressed. This should always be documented in the case file so that the Fund's business may then be wound up.

Conclusion

While their respective roles differ, judges, ADR professionals and litigators each have professional responsibilities that relate to achieving successful settlements. Armed with a better understanding of Section 468B Funds, courts will respond more knowledgeably and effectively when petitioned to approve them. Hopefully, mediators and arbitrators will be sufficiently informed about this settlement tool so they can identify appropriate cases and, with those parties' consent, integrate 468B planning as part of their mediation or arbitration process. And, most importantly, litigating attorneys are the ones who need to identify cases where their respective clients will be better served by using a Section 468B Fund, plan for that possibility as early as possible in those cases, and be aware of available resources to assist as needed.²¹

1. The term "claimants" is used here because 468B Funds may be used whether or not a particular "claimant" has yet become a "plaintiff" (i.e., settlements can and sometimes do occur before an action has been commenced). Elsewhere in this article, the terms "claimant" and "plaintiff" are sometimes used interchangeably.
2. I.R.C. § 468B was added to the Code by section 1807(a)(7)(A) of the Tax Reform Act of 1986, Pub. L. 99-514, § 1807(a)(7)(A), 100 Stat. 2814 (1986). The statute provides that a fund is a designated settlement fund ("DSF") if (1) it is established pursuant to court order; (2) it has the principal purpose of resolving and satisfying tort claims against the taxpayer (specifically, claims arising out of personal injury, death, or property damage); (3) it is funded entirely by qualified payments (specifically, money or property but not stock or any debt instrument); (4) it is administered by individuals unrelated to the taxpayer; (5) it completely extinguishes the liabilities involved; (6) its transferor has elected DSF treatment; and (7) neither its transferor nor related parties hold beneficial interests in the Fund's income or corpus. See I.R.C. § 468B(d)(1) and (2)(A-F).
3. I.R.C. § 461(h) governs when economic performance is deemed to have occurred if I.R.C. § 468B does not apply. I.R.C. § 468B(a) states, "For purposes of section 461(h), economic performance shall be deemed to occur as qualified payments are made by the taxpayer to a designated settlement fund." This means that the transferor to a 468B Fund can immediately claim a deduction for the amount contributed, and does not need to wait until the funds are distributed to beneficiaries.
4. I.R.C. § 468B was amended by section 1018(f)(5)(A) of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100-647, 102 Stat. 3582 (1988). In addition to directing Treasury to issue tax regulations for 468B Funds, this amendment added new subsection (g)(2) to I.R.C. § 468B, which exempts from taxation settlement funds established pursuant to a consent decree entered by a United States district court judge to resolve or satisfy claims under the Comprehensive Environmental Response Compensation and Liability Act of 1980 ("CERCLA"). I.R.C. § 468B(g)(2) tax-exempt settlement funds are not specifically addressed in this article.
5. Treas. Regs. §§ 1.468B-1 to 1.468B-5 (sometimes referred to as the "QSF regulations"). The QSF regulations were published as final regulations in the Federal Register on December 23, 1992. 1993-8 I.R.B. 6; 57 Fed. Reg. 60983 (1992). The QSF regulations were also validated and upheld in *United States v. Brown*, 348 F.3d 1200, 1217 (10th Cir. 2003).
6. See Treas. Reg. § 1.468B-1(c)(2)(ii) for the quoted language concerning claims allowable with QSFs. QSFs may also be used with claims asserting liability under CERCLA, or as designated by the Treasury in a revenue ruling or revenue procedure. Treas. Reg. § 1.468B-1(c)(2)(i) & (iii). See I.R.C. § 468B(d)(2)(D) concerning allowable claims with DSFs.
7. See I.R.C. § 468B(d)(2)(A) concerning the "established pursuant to a court order" requirement for DSFs. See Treas. Reg. § 1.468B-1(c)(1) concerning this expansion of the "established pursuant to" requirement for QSFs.
8. For a more comprehensive discussion of the single-claimant 468B Fund issue, see Robert W. Wood, *Single-Claimant Qualified (468B) Settlement Funds?* Tax Notes (Jan. 5, 2009); and Jeremy Babener, *Structured Settlements and Single-claimant Qualified Settlement Funds: Regulating in Accordance with Structured Settlement History*, 13 N.Y.U. J. Legis. & Pub. Pol'y 1 (2010).
9. Typically, this motion establishes that (a) the plaintiffs and the Fund administrator will agree as to the allocated amount and the form of distribution of each plaintiff's share of the settlement proceeds that are paid by the settling defendant(s) into the 468B Fund; (b) until such time as agreements are executed, no settlement proceeds shall be set apart for any individual claimant, or otherwise made available for him or her to draw upon or control such settlement proceeds; (c) determination of settlement terms with individual claimants will not involve the defendant(s), whose liability is completely extinguished as set forth in a Release and Indemnity Agreement;

(d) the Fund administrator is authorized to distribute immediately all attorney fees and costs to plaintiffs' counsel consistent with existing attorney/client fee agreements, and any further or subsequent court approval for distributing attorney fees and costs shall only be needed to the extent required by law (for example, where court approval is needed for the settlement of claims involving the interests of minors or protected persons); and (e) as soon as practicable upon entry of the order establishing the 468B Fund, its administrator will file with the court a declaration of supporting materials, including: (i) a Release and Indemnity Agreement that completely extinguishes the defendant(s)' liability; (ii) a Master Agreement among plaintiffs setting forth the allocation and form of the settlement; and (iii) an individual Fund Agreement and Release between the 468B Fund and each of the claimants.

10. Note 9 above sets forth one example of the terms of administration for a 468B Fund.
11. It is often appropriate to distribute all attorneys' fees promptly, in a single distribution, after (i) the Fund has settled with defendants and (ii) claimants' allocation of shares has been determined. In some cases, however, it is preferable to hold back a portion of attorneys' fees where additional work must still be performed by one attorney on behalf of his or her client, or by class counsel on behalf of the class as a whole. See, e.g., *In re Serzone Prod. Liability Litig.*, 2005 U.S. Dist. LEXIS 30468, 231 F.R.D. 221, 231 (S.D. W. Va. 2005).
12. Unless a particular Fund invests only in tax-free municipal bond funds (free of all federal, state and local income tax liabilities), income tax filings need to be made and any income tax liability paid for each year the Fund is in existence.
13. See, e.g., Local Rules of Practice under Fed. R. Civ. P. 67 (Deposit in Court), D. Utah Civ. R. 67-1(b).
14. See *Continental Cas. Co. v. United States*, 2006 WL 3455055 (N.D. Cal. Nov. 29, 2006). However, some courts have been persuaded by plaintiffs to order defendants to pay agreed settlement amounts into a 468B Fund. See, e.g., Order Granting Motion for Expedited Relief, *Hart v. Anchondo*, No. Civ. 06-1153 MCA/WDS, at *8, ¶¶ 4-5 (D. N.M. Jan. 17, 2008); and, in its related case, Order Establishing the Nuñez Segregated Account and Appointing Administrator, *In re Nuñez Segregated Account*, No. 2007-538, 250 (Lubbock County Court at Law No. 3, Tex., Oct. 31, 2007). In such instances, objecting defendants may move the court to order that they be granted appropriate rights of indemnification or be otherwise immunized from liability, in the event that (i) it is later determined the Fund is not eligible for tax treatment as a Section 468B Fund, or (ii) there is any other liability or potential liability that arises in the course of administering the 468B Fund.
15. See Treas. Reg. § 1.468B-1 (as amended in 2006). For example, a 468B Fund may be created in a probate court or proceeding that has jurisdiction over the settlement interests of those claimants who are minors or who are otherwise legally disabled. For further discussion of these issues (including whether 468B Funds may be established over defendant's objection or even without defendant's knowledge), see Jeremy Babener, *Structured Settlements and Single-claimant Qualified Settlement Funds: Regulating in Accordance with Structured Settlement History*, 13 N.Y.U. J. Legis. & Pub. Pol'y 1 (2010) at footnotes 380-396 and corresponding text.
16. See notes 12 above and 19 below for additional discussion of how Section 468B Funds are taxed.
17. For example, some claimants or their counsel may prefer to work with settlement planning specialists in whom they have confidence, and do so at their own expense. When special needs trusts are being drafted for any particular claimant, this is typically done at that claimant's own expense.
18. In using 468B Funds, this author has at times specified that investment of proceeds shall be limited to (a) a particular corporate account that invests only in Certificates of Deposit in a pool of federally insured institutions, with not more than the FDIC-guaranteed limit of the Fund's assets to be placed in any one bank; or (b) a particular mutual fund for which investments are limited to debt obligations of the U.S. government.
19. Compensation of the Fund administrator is a cost of administration that can be claimed as a deduction against investment income earned by the Fund. See, e.g., Federal Procedural Forms § 11:171 (this form is a sample provision that may be included in a stipulation for settlement of a class action, concerning the tax treatment of a settlement Fund, as required under Rule 23(e)(3) of the Federal Rules of Civil Procedure). Under that rule, parties seeking approval of a settlement must file a statement identifying an agreement that is made in connection with a proposed settlement (for example, as in this sample form, as to what expenses shall be considered a "cost of administration" of the settlement Fund).
20. Notwithstanding possible new MMSEA § 111 Transferor Reporting Rules, see *In re Serzone*, 231 F.R.D. at 233-34. That court-administered settlement agreement included lien hold-back provisions that protected both the settling defendant and the claimants (some of whom faced lien obligations under the Medicare Secondary Payer Act or unpaid child support that attached as liens in various states, plus other federal, state and private lien and subrogation demands). This did not prevent the court from approving the settlement as fair, allowing the settling defendant to pay a large sum to the 468B Fund and obtain a binding release. Each claimant was required (and thereby enabled) to negotiate with lienholders before receiving any settlement proceeds from the Fund. This increased the claimants' ability to negotiate lien resolutions on favorable (discounted) terms in advance of receiving a distribution from the Fund. Lien hold-back procedures of the type approved by the court enabled the defendant to avoid potential claims by lienholders, while enabling claimants to resolve their liens more effectively.
21. Recent and useful publications on 468B include the legal treatise by tax attorney Robert W. Wood, *Qualified Settlement Funds and Section 468B* (Tax Institute 2009), and the law review article by Jeremy Babener cited at notes 8 and 15 above.



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