

Quest for yield fuels interest in risky investment vehicle

By Darla Mercado

September 25, 2011

Yield-starved investors and their advisers are discovering a complex investment vehicle: annuities awarded in wrongful-death or injury lawsuits that are being sold as factored structured settlements.

The 7% yield on these products is attractive at a time when five-year certificates of deposit return around 2%, and fixed annuities yield just slightly more.

“Broker-dealers are looking at this as an opportunity to get their brokers in front of a retail client with a unique product,” said William D. Coluccio, chief executive of Altium Group LLC, a general agency that offers secondary-market structured settlements.

In purchasing a factored structured settlement, an investor essentially is buying the right to the money awarded to a victim or family members in the form of a fixed annuity.


Here's how it works: a plaintiff agrees to receive his or her settlement as a steady stream of income paid from an annuity over a period of many years. He or she then sells (at a significant discount) the rights to that income stream to a factoring company, in exchange for a one-time lump sum payment. The factoring company then sells the rights to that annuity payment to an individual investor in a secondary market through an adviser, broker or insurance agent.

As if that weren't complicated enough, changing the recipient of the annuity stream from the plaintiff to an investor requires the permission of a judge.

“It's not exactly easy to get this at first glance, and it's hard to explain the business in an elevator conversation,” said Matt Bracy, general counsel of Settlement Capital Corp. “Our typical investors are sophisticated, have investigated this a bit and are represented by counsel.”

To be sure, factored structured settlements are not for everyone — or even most people. This instrument remains essentially unregulated by the Financial Industry Regulatory Authority Inc. or by insurance regulators.

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That means it's up to financial advisers and brokers to decide for themselves what kinds of disclosures and best practices are involved in offering factored structured settlements to clients. That takes time, legal expertise and the approval of the broker-dealer to run it as an outside business activity.

"There is an extensive checklist we go through when arranging these deals," said Tom Hamlin, founder of Somerset Wealth Strategies Inc. "There are definitely potential pitfalls, but if you have the proper tools, you can navigate the minefield."

Once a factored structured settlement has been sold, it's largely illiquid. In other words, the buyer cannot transfer ownership to anyone else.

As for the higher yields, those figures are based on the discount rate the factoring company uses to determine how much the plaintiff received in a lump sum, industry experts said.

Brokers selling the product to their clients typically collect commissions of 3% to 7%, according to Mr. Coluccio.

About 15 factoring companies are selling structured settlements to individual investors through advisers, brokers or other intermediaries, said Earl S. Nesbitt, an attorney with Nesbitt Vassar McCown & Roden LLP and executive director of the National Association of Settlement Purchasers.

While no one tracks the number of deals done each year, Mr. Nesbitt puts that number at about 5,000 — 1,000 to 1,200 of which involve individual investors. The rest are sold mainly to institutional investors, he said.

No matter what protections are offered, some broker-dealer executives remain wary.

"It doesn't fall into the activity considered by a broker-dealer, and it doesn't fall under the rules for disclosure and advertising," Caleb Callahan, vice president of investment marketing at ValMark Securities Inc., said of factored structured settlements. "It's an area with a potential for abuse."

Representatives at his broker-dealer have been approached about offering structured settlements, but the firm is confounded as far as how to treat the products.

Others executives avoid the product out of concern that the broker-dealer could get tied into it, even if it's an outside business activity.

"You could go through a variety of steps and disclosures to mitigate client confusion that this is something offered by the broker-dealer, but the firm has more at stake," said Paul Tolley, chief compliance officer at Commonwealth Financial Network.

Advisers who offer factored structured settlements to their clients need to hire a team of legal experts to review the processes before bringing the matter to their broker-dealer for approval, experts said.

Mr. Hamlin, who has been offering structured settlements for about two years, said his cases

include a legal review by an independent attorney, which costs between \$750 to \$1,250 per file. The cost of the legal work can vary according to the complexity of a plaintiff's file, which can comprise hundreds of pages.


Investors also are notified that the payment stream is potentially illiquid. Without an outline for best practices, Mr. Hamlin also has used suitability questions based on the current regulatory framework for annuity sales.

The transaction can take several months to close and several more months to get a broker-dealer to approve the use of structured settlements as an outside business activity.

All in all, it can take up to six months for an adviser to get the OK to use the products — provided he or she has set up the proper safeguards.


“This transaction is less like buying an annuity and more like buying a house,” Mr. Hamlin said. “Who's looking out for us? That's why we've surrounded ourselves with a handful of the top attorneys across the country as it pertains to this asset class.”

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