December 5, 2005

TAX ISSUES/ MEDICAID/MEDICARE ISSUES

Edgar C. Gentle, III, Esq.
Gentle, Pickens & Turner
2 North 20th Street
Suite 1200
Birmingham, Alabama 35203
(205) 716-3000

Disclaimer: These seminar materials do not constitute legal advice.

A. TAX ISSUES

I. INTRODUCTION.

The Federal and Alabama income tax consequences to litigants resulting from a judgment or settlement may significantly impact its economic consequences. There may be great opportunity to influence the tax impact of the settlement. However, usually tax issues are not considered until the opportunity for meaningful planning has already passed. The moral is plain: begin planning for the desired tax result of a settlement or a judgment from the beginning of the suit - even before the complaint is filed.

Usually, this matter is thought to involve a simple dichotomy: Is it taxable or not? However, capital gains treatment as opposed to ordinary income treatment is significant, because the maximum capital gains rate is 15% and the maximum ordinary income rate is 35%. Corporate plaintiffs have a lesser interest in the capital/ordinary income distinction since corporations are currently not entitled to a preferential capital gains rate. However, even a corporate plaintiff has the obvious advantage to capital treatment because there often will be a basis in the affected asset against which some of the recovery can be sheltered. When there is capital gains treatment, the taxable amount is usually the excess of the award over the basis in the property.

From the defendant's perspective, the difficulty in accepting the settlement will be greatly impacted by whether the payment is fully tax deductible, partially deductible or wholly non-deductible.

Considerations of the tax implications frequently influence settlement negotiations and in some cases even influence judgments.

It seems clear that the tax consequences of a settlement or judgment should be considered in virtually every case. Not to do so may subject an attorney to a malpractice claim. Graham v Harlin, Parker & Rudloff, 664 S.W. 2d 945 (Ky.Ct.App. 1983); Philips v Giles, 620 S.W. 2d 750 (Tex. Civ. App. 1981).

This is a very complex subject, and I would encourage you to consult with a tax attorney in connection with any significant lawsuit or settlement. Below is an overview of the issues from both the plaintiff's and the defendant's perspective.

The most enduring principle applicable to this area of the tax law is that the tax result of a particular settlement award or judgment should be determined by reference to the underlying claim which the lawsuit seeks to address. Succinctly stated, the crucial inquiry is: "In lieu of what were the damages awarded?" Raytheon Production Corp. v. Commissioner, 144 F. 2d 110 (1st Cr. 1944), cert denied, 323 U.S. 779 (1944).

II. PLAINTIFF RECOVERY TAXABILITY GROUND RULES

A. Receipts in the Hands of the Client.

In this section we will not address the contingency fee received by the lawyer, but only what the client, himself, gets. There are three categories: not taxable, taxable ordinary income and taxable capital gains.

(i) Non-Taxable. The Internal Revenue Code (the "Code") (Alabama is a so-called sponge tax state, almost uniformly following the Federal income tax laws in deciding what receipts are taxable for State income tax purposes.) specifically excludes compensatory damage recoveries from personal injury or physical sickness and proceeds of will contests from taxability. Code §§ 104 and 102. These exclusions encompass personal injury and sickness awards from workman's compensation, accident and health insurance, and pension or annuity plans. Also excluded are divisions of property incident to a divorce. Code § 1041. Alimony, however, is usually deductible by the payer and taxable to the recipient.

In contrast, punitive damages are almost always taxable after the passage of the Small Business Job Protection Act of 1996, which substantially amended Code § 104. O'Gilvie v U.S., 519 U.S. 79 (1996).

Wrongful death recovery in Alabama is a hybrid. Even though all damages are punitive in nature, they historically have not been taxable. Burford v U.S., 642 F. Supp. 635 (N.D.Ala. 1985). This treatment appears to be preserved by Code § 104(c)(1) and (2), providing that punitive damages, which normally may be taxable for Federal income tax purposes, do not include punitive damages awarded in a civil action for wrongful death and with respect to which applicable state law in effect at September 13, 1995 provides that only punitive damages may be awarded. This is the case in Alabama. Campbell v Williams, 683 So. 2d 804 (Ala. 1994), cert. denied, 513 U.S. 868 (1994).

(ii) Taxable As Ordinary Income. Recoveries for replacing income are generally taxable in the same manner as the income that was lost. This includes damages for lost wages or that are measured by reference to lost wages, such as back-pay awards (including back-pay awarded in civil rights cases), damages for breach of service or supply contracts, compensation for lost business profits (including antitrust, unfair competition, patent and copyright infringement recoveries, and recoveries for lost royalties, interest or rent). Taxable recoveries are often, but not always, a result of a contract or business tort claim or a statutory claim analogous to such claim. Such taxable awards include recoveries for injuries to reputation such as libel and defamation. As stated above, punitive damages are almost always taxable. Forgiveness of indebtedness (to the extent that some or all of the debt is written off), such as negotiating a reduced payment by the claimant to discharge a mortgaged indebtedness, may be taxable, as may be the defendant's agreement to pay debts of the claimant. An exception to these debt forgiveness or third party payment rules may be realized in bankruptcy. Code § 108.

(iii) Halfway House: Recovery of Capital. Payments for property damage or loss of property rights are an untaxed recovery of capital to the extent that the recovery does not exceed the claimant's basis in the property. Any excess is taxed. The claimant's basis in the property is reduced by the amount of the recovery. In addition to traditional real estate or tangible personal property damages, intellectual property damages, such as recoveries from securities litigation, shareholder derivative suits and antitrust cases, may also be capital recoveries. If the property or property right is lost, destroyed or surrendered and the amount of the recovery is less that the basis, the claimant may realize a deductible loss equal to the difference between the basis in the property and the amount of the recovery.

The IRS often debates whether a settlement payment is ordinary income or capital gains treatment, insisting that, to obtain capital gains treatment, there must be " a sale or exchange of property." Revenue Ruling 74-251, 1974-1 C.B. 234. Thus, if the complaint alleges harm or virtual extinguishment of capital assets as opposed to mere lost profits, prospects for capital gains treatment may be improved. Harm to capital assets, such as toxic chemical damage to real estate, is deemed to result in an exchange justifying capital gains treatment. Revenue Ruling 68-378, 1968-2 C.B. 335.

(iv) Form of Recovery and When Taxable. Theoretically, the taxability of the client recovery is not affected by how the recovery was obtained, whether it is from a judgment or a settlement. If the underlying transaction being litigated would have been taxable then the judgment or settlement ending the dispute should be taxable as well. If the underlying transaction being litigated would not have been taxable, then the award should not be. The underlying claim may be partly non-taxable, partly taxable, partly a recovery of capital, and partly excludable. An example would be a car wreck case, with excludable medical expenses, taxable lost earnings, capital loss damages for totaling the car, and non-taxable personal injury. Note: allocating a recovery among damages categories in a settlement agreement may be given some weight by the IRS, but is frequently challenged on audit. See B. E. McKay, Jr. 102 T.C. 465, CCH Dec. 49,736. The settlement document generally should include an allocation of recovery damages to help the plaintiff with her tax planning. Since individuals are almost always cash basis and not accrual basis taxpayers, recoveries usually are not potentially taxable to the claimant until he receives the check, providing tax planning opportunities if a payment can be delayed until the following year.

(v) Involuntary Conversions and Disaster Relief

If, for example, a taxpayer is paid for the destruction of his home by a hurricane or fire and subsequently uses the proceeds to purchase a replacement home, the payment to the taxpayer may be entitled to non-recognition treatment as an involuntary conversion of the old home for the new under Code § 1033. Allen v Commissioner, T. C. Memo 1998-406. Surprisingly, however, the IRS has concluded in the past that state flood relief efforts for payments caused by Hurricane Floyd should be included in the recipient's gross income and reported by the state on Form 1099. ITA 200013030(March 31, 2000). See also, Code § 6041.

B. Taxability to the Plaintiff of His Attorney's Fees.

(i) A Safe Harbor: Where a Client's Share is Non-taxable.

For cases falling within category II A(i), above, both the portion received by the client and the portion received by the attorney are generally not gross income to the client, with the attorney's portion also not being deductible by the client. Here, no income tax issue.

(ii) Where Client's Payment is Taxable: The Battleground.

Until the United States Supreme Court addressed Commissioner v. Banks and Commissioner v. Banatis, recently, there was a split of authority on client income tax treatment respecting he lawyers' attorneys' fees.

Alabama in E. W. Cotman, CA-5, 59-1 U.S.T.C. ¶ 9200, had found that a contingent attorneys' fee is not income to the taxpayer under the theory that, in our state, the attorney's lien operates to transfer ownership of the contingency fee portion of an award to the attorney. Other states, such as Alaska, California and Arizona have disagreed with Alabama, while Texas and Michigan have agreed.

In states disagreeing with Alabama, the entire recovery (client's share and lawyer's share) for cases in this category would be taxable to the client, but with the client being able to deduct the lawyer's fees as a miscellaneous income production expense under Schedule A of his income tax return. However, such a deduction is only allowed to the extent that client's the total miscellaneous itemized deductions exceed 2% of his adjusted gross income that year. In addition, the amount allowable as a deduction is subject to a reduction if the claimant's adjusted gross income exceeds a threshold amount of $145,950 in 2005. Finally, the attorney's fee deduction is not allowed for alternative minimum tax purposes. Because of such limitations, a client often ends up paying income tax on the gross award or settlement with no deduction for fees paid to the attorney.

In the Banks and Banatis case, the United States Supreme Court followed the Arizona Rule in the context of unlawful employment discrimination cases where the attorneys' fee was determined by a fee contract with the claimant. We can expect the Internal Revenue Service to try to apply this precedent to all recoveries in this category, except as qualified below.

Note, however, that (i) in Banks/Bantis, the Supreme Curt did not decide whether fees paid directly to a lawyer pursuant to a fee shifting statute or order (RICO and the Sherman Act come to mind) constitute gross income to the claimant; and, (ii) for cases arising after October 23, 2004 (legislation effective date), the Supreme Court has been overruled in employment discrimination cases by the Federal Civil Rights Tax Relief Act ("CRTRA"), which allows the taxpayer to reduce his adjusted gross income by the amount of attorneys' fees paid in such cases, whether they are paid by the employer under a statutory fee shifting provision or by the plaintiff, or if it is part of a settlement agreement. The CRTRA seems to apply to recoveries under the following laws (and may apply to others):

- the Civil Rights Act of 1991;
- 42 U.S.C. So. 1981;
- the Congressional Accountability Act of 1995;
- the National Labor Relations Act;
- the Fair Labor Standards Act of 1938;
- the Age Discrimination in Employment Act of 1967;
- the Rehabilitation Act of 1973;
- the Employee Retirement Income Security Act of 1974;
- the Education Amendments of 1972;
- the Employee Polygraph Protection Act of 1988;
- the Worker Adjustment and Retraining Notification Act;
- the Family and Medical Leave Act of 1993;
- Chapter 43 of Title 38 of the United States Code;

- Sections 1977, 1979, or 1983 of the Revised Statutes;
- the Civil Rights Act of 1964;
- the Fair Housing Act;
- the Americans with Disabilities Act of 1990;
- any provision of federal law (popularly known as whistleblower protection provisions) prohibiting the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted under federal law; or
- any provision of federal, state or local law, or common law claims permitted under federal, state or local law providing for the enforcement of civil rights or regulating any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.

Clients with ordinary income taxable recoveries not covered by CRTRA remain in income tax jeopardy with respect to attorney's fees.

(iii) <u>Capital Loss Recoveries: A Hybrid Result</u>.

If the amount of the gross recovery is equal to or less than the client's basis in the property, the non-taxability of the recovery is not changed by the client paying some of it to the attorney as a fee. Whether that portion of the recovery does or does not reduce the client's tax basis upon a future sale of the property is debatable . If the recovery exceeds the basis, it is taxable to the client. However, the client may wish to allocate this portion of the recovery to the attorney's fee and try to deduct it on Schedule A, though the IRS would probably reallocate the payment to a ratable split between taxpayer and lawyer. If the recovery is not greatly in excess of the basis, deductibility may be feasible, depending upon the taxpayer's income tax status for the year, as suggested above.

III. TAX TREATMENT TO THE DEFENDANT

A. General Rule: Deductible For Business Defendant If There Is A Business Nexus.

Provided that the damages payment may be reasonably characterized as either a general business expense under Code § 162 or paid or incurred in connection with an investment or for the production of income under Code § 212, it is deductible for income tax purposes. Note: because Code § 212 expenses are not deductible for purposes of the Alternative Minimum Tax, a defendant may wish to attempt to recharacterize his investment or other income production business sideline as a full blown business if he gets sued.

The deduction is usually allowed in the year where the settlement payments first are placed irrevocably beyond the taxpayer's control. Edison Brothers Stores, Inc. v. Commissioner, T.C. Memo. 1995-262. Code § 468B.

Another impact on the timing of the deduction is whether the payment should be capitalized and therefore only deducted over time through depreciation or is immediately deductible as a business expense. For example, in United States v Wheeler, 311 F. 2d. 60 (5th Cir. 1963), cert. denied, 375 U.S. 818 (1963), a payment in settlement of a lawsuit for the specific performance of a contract to sell stock was held to be a non-deductible capital expenditure by the defendant rather than an immediate business expense, because the settlement was made to protect its title to stock.

Alternatively, an accrual method tax payer may be able to deduct a damages payment in the year when the liability for payment is fixed and the amount of the payment is determined with reasonable accuracy. Treasury Reg. § 1.461-1. Thus, if a settlement agreement is signed at the end of the year and the payment is not paid until the following year, the deduction may arguably be taken by an accrual taxpayer in the previous year.

Occasionally, the business nexus is challenged. See United States v Gilmore, 626 F 2d 59 (4th Cir. 1980), where the expenses of divorce litigation were held to be non-deductible as a personal expenditure even though an adverse decision in the matter was likely to destroy the taxpayer's business. The origin of the claim - the divorced litigation - rather that its potential consequences to the business, was held to control. Likewise, in Kelly v. Commissioner, T.C. Memo 1999-69, legal costs of defending against a criminal sexual harassment charge were found to be non-deductible as arising out of individual personal activities and not business activities.

Legal fees and expenses related to the actions of officers and directors to defend cases for breach of fiduciary duty are usually deductible on the theory that the matter relates to the corporation's business. Century Foundry v. Commissioner 49 T.C. 234 (1967).

The fact that a liability is based upon the taxpayer's fraud, breach of fiduciary duty or other misdeeds is generally not enough to prevent the payment from being deductible as long as the liability was incurred in connection with the taxpayer's trade or business. Helvering v Hampton 79 F. 2d. 358 (9th Cir. 1935)

B. Exceptions to the Rule.

There have been several legislative proposals to make punitive damages non-deductible to deter defendants. However, so far, none have become law. However, fines or penalties paid to governmental entities are usually non-deductible. If a payment is illegal either under federal or state law, the deduction will be disallowed. Thus, where a taxpayer sought to deduct a payment made to an arsonist to burn down his building, no deduction for the arsonist payment was allowed. Revenue Ruling 82 - 74, 1982-1 C.B. 110.

C. Payments Made By Corporate Affiliates.

If one business's settlement obligations are paid by an affiliate, the payment will not give rise to a business expense deduction for the paying affiliate unless the payments are made to protect the affiliate's credit standing or fulfill another reasonable affiliate business purpose. Fancy Foods of Virginia, Inc. v U.S., 31 A.F.T.R. 2d. 73-1311 (E.D. VA. 1973). Sometimes, the reasonable business interest test may be satisfied if the affiliate thereby promotes its own services or standing with customers. Lohrke v Commissioner, 48 T.C. 679 (1967).

D. No Deduction for Fines and Penalties.

Under the Code, no deduction is allowed for "any fine or similar penalty paid to a government for the violation of any law." Code § 162(f). This provision has been held to deny a deduction for both criminal and civil penalties, as well as for sums paid in settlement of potential liability for a fine. Reg § 1.162-21(b). Allied - Signal, Inc. v Commissioner, 54 F.3d 767(3rd Cir. 1995), the taxpayer was not allowed to deduct an $8 million payment into a trust to eradicate a toxic chemical pesticide from the environment because the payment was made with the virtual guarantee that the District Court would reduce a criminal fine by at least the same amount.

An exception to the rule is found in Jenkins v Commissioner, T.C. Memo 1996 - 539, where a state fine payment was held to be deductible because it was meant not to punish the manufacturer but to compensate harmed consumers.

The line between compensatory fines and non-compensatory ones is difficult to discern. For example, the Treasurer Regulations take the position that payments for civil environmental fines are non-deductible. Treasury Reg § 1.162-21(c). Yet, a payment to the Clean Water Fund in order to avoid prosecution for water pollution was held deductible in S & B Restaurant, Inc v Commission, 73 T.C. 1226 (1980).

Restitution payments arising out of a criminal action for fraud are not deductible in some instances but are deductible in others. Compare, Kraft v United States, 1991 F. 2d. 292 (Cir. 1993) and Stephens v. Commissioner, 93 T.C. 108 (2d. Cir. 1990).

Unfortunately, because fines are generally non-deductible, attorneys' fees incurred in defending against them have also been held non-deductible on the theory that they are tainted by the nature of the litigation. Burroughs Building Material, Co. v Commissioner, 47 F.2d. 178 (2d Cir. 1931).

E. Damages Trebling Under the Antitrust Laws or RICO.

Only one-third of treble damages under the Federal antitrust laws are deductible if the first third of the damages represents compensatory damages and there is a conviction or a plea of guilty or nolo contendere in a related criminal proceeding. Code § 162(g). Since this Code section does not apply to RICO, it seems that all RICO damages should be deductible, although this could be debated. Surprisingly, legal fees may not be deductible in defending a RICO action. Accardo v Commissioner, 98 T.C. 165 (1992).

IV. TAX PLANNING BY THE PARTIES

A. The Complaint and the Settlement Agreement.

Clearly, in drafting the plaintiff's complaint, thought should be given to providing favorable damages payment harbors in the requested relief. Thus, except in wrongful death where you don't have a choice, compensatory damages should always be requested even if punitive damages are added. If there is a capital asset in sight, such as real estate or a car, loss or destruction of capital might reasonably be pleaded, so as to allow allocation of some damages to this bucket that is favorable for two reasons: a lower tax rate and income sheltering through the basis in the asset.

Understandably, the defendant, in answering and defending a case, is probably not thinking about the tax benefits to the plaintiff. As suggested above, assuming the defendant is a business, a settlement or judgment payment is usually deductible by the defendant.

However, at the settlement stage, as suggested above, the business defendant has more flexibility in connection with the deduction of his payments than the plaintiff has in sheltering the payments from taxability. There is no incentive for the business defendant not to cooperate with the plaintiff in characterizing all damages in the settlement agreement as compensatory (except for wrongful death). Indeed, it is good PR for the defendant. Moreover, there is no harm to the plaintiff in allowing the business defendant to recite in the settlement agreement that the damages paid were ordinary and necessary business expenses under Code § 162.

B. Qualified Settlement Funds and Structured Settlements.

A simple solution to any debate between the plaintiffs and defendants with respect to income tax issues for large settlements may be the Qualified Settlement Fund ("QSF") under Code § 468B, allowing defendants to deduct all payments. A claimant payment matrix tailored to claimant damages and addressing tax concerns can be designed by the claims administrator later.

Example: In the Tolbert PCB Settlement in Anniston, involving 18,000 claimants, the defendants paid and presumably deducted $275 million into a QSF. Subsequently, damages were allocated between compensatory personal injury damages and property injury damages (which are not taxable until the payment received by the claimant exceeds her basis in the property). The two payments are made by separate checks with two different colors, and the claims administrator worked with the IRS to obtain the attached agreed description of the income tax consequences of settlement payments to claimants, which is mailed with each claimant check.

Large tort settlement payments to claimants, even if they are not deductible at the time of receipt, may result in income tax headaches later because of tax on subsequent earnings after the payment is disbursed to the claimant and invested. If, instead, the claimant receives periodic payments through what is called a structured settlement under the Periodic Payment Settlement Act of 1982, the plaintiff's subsequent receipt of the lump sum in installments and the income on the installments over time will be completely income tax free. Note: To have a structured settlement, the claimant cannot actually or constructively receive the settlement payment. It must go to the structured settlement instead. What do you do if the defendant is in a rush to pay you the settlement amount and your client is considering a structured settlement? Do not put it in your trust account, this is constructive receipt. Do create a QSF.

If, later, the claimant wishes to receive more than his structured settlement periodic settlement payment, lenders are available and the resulting lump sum or factoring payments so received are also apparently excluded from income. Private Letter Ruling 199936030. Thus, the benefits of such a tax free treatment of structured settlement recoveries go far beyond normal income tax referral. They actually result in fewer dollars being subject to tax.

The defendant usually funds a structured settlement through the purchase of an annuity contract, with the defendant's income tax deduction usually being limited to the actual cost of the annuity. Ford Motor Company v Commissioner, 102 T.C. 87 (1994), affirmed 71 F 3d. 209 (6th Cir. 1995).

C. Ethical Tax Planning.

Ethically and legally, counsel on both sides of the case probably have a duty to their client to explain the tax consequences of a potential settlement and the related settlement alternatives before finalizing the settlement.

B. BRIEF OVERVIEW REGARDING IMPACT OF MEDICARE AND MEDICAID ON SETTLEMENTS.

I. INTRODUCTION

If Medicare or Medicaid provided medical assistance to the plaintiff in connection with injury, disease, or sickness which was arguably caused by the defendant, as was alleged in the complaint or determined in a judgment or settlement, Medicare and Medicaid may claim a to be subrogated to the plaintiff's rights of recovery against the defendant for causing the injury, disease, or sickness. This may be a straightforward inquiry for a car wreck caused by a defendant with resulting medical costs. It is far from simple, for example, (i) in medical products cases, such as the MDL 926 Breast Implant case described in the Medicare case of U.S. v Baxter, 345 F.2d. 866 (11th Cir. 2003), in which I was a defendant as the settlement escrow agent, or (ii) for toxic tort cases, such as the Anniston Tolbert PCB Settlement, where I am the claims administrator.

In both cases, plaintiffs' counsel, in their zeal, alleged that breast implants and PCBs caused a wide variety of personal injuries, whose care would be subject to Medicare or Medicaid. Defendants' alleged that implants and PCBs are safe. As a result, we engaged in seemingly endless and grueling negotiations with Medicare over this causation question and other issues, with negotiations lasting ten years in the implant case and two years in the PCB case prior to reaching a written settlement agreement.

Sometimes these settlements result in the agency obtaining a fraction of what it originally claimed was owed, such as the PCB settlement's agreement with the Alabama Medicaid Agency to pay 10% of the Medicaid Agency's claims, or the settlement amount may relate to what the claimant receives, such as our settlement with Medicare in the PCB case for Medicare claimants to pay 10% of what they are due to receive for personal injury.

Further, in addition to the subrogation right, Medicare may be entitled to reimbursement for any benefits it paid to claimants for injuries, diseases, or sicknesses that were allegedly caused by the defendant if the defendant (or its insurer) is considered a primary payer under the Medicare Secondary Payer Statute (the "MSP") as discussed below. Medicare may also construe the MSP to apply to plaintiffs' lawyers and claims administrators, Baxter, supra.

Before the United States Supreme Court in Arkansas Department of Health and Human Services v Ahlborn, 397 F. 3d. 620 (8th Cir. 2005), on certiorari, is the important question of whether Medicaid or Medicare liens entitle the state and federal government to 100% reimbursements from personal injury settlement proceeds regardless of which portion of the settlement proceeds are designated as compensation for medical care and before any proceeds of the settlement or judgment can go to the plaintiff. This decision may greatly impact the ability of counsel to limit Medicaid and Medicare lien exposure from a settlement possibly based upon how much is allocated to medical care in the settlement agreement. A favorable result may also lessen the current burden in settling Medicare cases, because government counsel often does not allow their recovery to be compromised and appear to be in no hurry to resolve issues.

II. Medicare's Right to Subrogation

Medicare may recovery for payments made to claimants is under the Medical Care Recovery Act (the "MCRA"). 42 U.S.C. § 2651(a) states the following:

> In any case in which the United States is authorized or required by law to furnish or pay for hospital, medical, surgical, or dental care and treatment ... to a person who is injured or suffers a disease ... under circumstances creating a tort liability upon some third person ... to pay damages therefor, the United States shall have a right to recover (independent of the rights of the injured or diseased person) from said third person, or that person's insurer, the reasonable value of the care and treatment so furnished, to be furnished, paid for, or to be paid for and shall, as to this right be subrogated to any right or claim that the injured or diseased person, his guardian, personal representative, estate, dependents, or survivors has against such third person to the extent of the reasonable value of the care and treatment so furnished, to be furnished, paid for, or to be paid for.

42 U.S.C. § 2651(a).

III. Alabama Medicaid's Subrogation Statute

Alabama Medicaid has a subrogation statute. Alabama Code § 22-6-6(a) states the following:

> If medical assistance is provided to a recipient under the Alabama Medicaid Program for injuries, disease or sickness caused under circumstances creating a cause of action in favor of the recipient against any person, firm or corporation, then the State of Alabama shall be subrogated to such recipient's rights and shall be entitled to recovery the proceeds that may result from the exercise of any rights of recovery which the recipient may have against any such person, firm or corporation to the extent of the actual amount of the medical assistance payments made by the Alabama Medicaid Program.

Ala. Code § 22-6-6(a).

However, it should be noted that subrogation by Alabama Medicaid has been held to be an equitable principle, not a strict right. Smith v. Alabama Medicaid Agency, 461 So. 2d 817, at 818 (Ala. Civ. App. 1984). Therefore, subrogation depends on the facts of each case. In Smith, the Court of Civil Appeals of Alabama recognized that the subrogation statute does not necessarily require recovery of all assistance paid by Medicaid. Rather, the amount recovered should be based on equity. Thus, Medicaid may not be entitled to recovery all payments it made for medical assistance to claimants, but it will be entitled to at least recovery of some of its payments.

In Smith, the Court of Appeals weighed the relative size of the recovery ($100,000) and the Medicaid lien ($7,000), in determining that the entire lien should be paid. The Court also found that the plaintiffs' attorney is due a fee from Medicaid for the amount paid under the lien.

IV. Medicare as a Secondary Payer: Defendant at Risk.

Under 42 U.S.C. § 1395y, known as the Medicare Secondary Payer ("MSP") Statute, Medicare is considered a secondary payer and can seek reimbursement of medical payments made for a service to one of its insureds that was or should have been provided by the primary payer. The basic function of the MSP statute is summarized as follows:

> [I]f payment for covered services has been or is reasonably expected to be made by someone else, Medicare does not have to pay. In order to accommodate its

> beneficiaries, however, Medicare does make conditional payments for covered services, even when another source may be obligated to pay, if that other source is not expected to pay promptly.

U. S. v. Baxter, 345 F.3d 866, 876 (11th Cir. 2003).

Payment is not supposed to be made by Medicare for services when "payment has been or can reasonably be expected to be made *promptly (as determined in accordance with regulations)* under a workmen's compensation law or plan of the United States or a State or under an automobile or liability insurance policy or plan (including a self-insured plan) or under no-fault insurance." 42 U.S.C. § 1395y(b)(2)(A)(ii). (The italicized portion has been stricken by Public Law 108-173, formerly known as H.R.1, Medicare Prescription Drug, Improvements, and Modernization Act of 2003).

Public Law 108-173 clarifies the meaning of "self-insured" under § 1395y(b)(2)(A)(ii) by adding the following, "An entity that engages in a business, trade, or profession shall be deemed to have a self-insured plan if it creates its own risk (whether by a failure to obtain insurance, or otherwise) in whole or in part."

If Medicare does make a payment of a service covered under 1395y(b)(2)(A)(ii), such payment is conditioned on repayment by the primary payer. 42 U.S.C. § 1395y(b)(2)(B)(i). Public Law 108-173 states the following regarding reimbursement, "A primary plan, and an entity that receives payment from a primary plan, shall reimburse the appropriate Trust Fund for any payment made by the Secretary under this title with respect to an item or service if it is demonstrated that such primary plan has or had a responsibility to make payment with respect to such item or service."

Section 1395y(b)(2)(B)(iii) states, "The United States shall be subrogated (to the extent made under this subchapter for such an item or service) to any right under this subsection of an individual or any other entity to payment with respect to such item or service under a primary plan." The

Secretary may waive the reimbursement requirement for an individual claim if the Secretary determines waiver would be in the best interest of the Medicare program. 42 U.S.C. § 1395y(b)(2)(B)(iv).

In order for defendant, in connection with its payments to the plaintiff, to by required to reimburse the United States for payments Medicare made to the plaintiff, the defendant must be considered a primary plan or an entity that receives payment from a primary plan. For the defendant to be classified as a primary plan, it will likely have to be considered self-insured because it probably does not qualify as the other types of primary plans listed in 42 U.S.C. § 1395y(b)(2)(A)(ii).

In Baxter the Eleventh Circuit held that the breast implant manufacturers who made personal settlement payments to a QSF were self insured. It did so while recognizing that "self-insurance" did not have a precise legal definition. See Baxter, 345 F.3d at 896. Because no precise definition existed at the time of Baxter, the Court gave great deference to the language found in the regulations regarding self-insurance plans. The regulations state that a self-insurance plan is a "plan under with an individual, or a private or governmental entity, carries its own risk instead of taking out insurance with a carrier." Baxter, 345 F.3d 866,895 (quoting 42 C.F.R. § 411.50(b)). The Court further found that the regulations required an initial arrangement to assume legal liability and carry its own risk rather than obtaining insurance. The Court found that there was evidence that the breast implant manufacturers had a plan or arrangement in place for paying product liability claims by breast implant recipients before the claims arose, and thus paid such claims from self-insured funds.

The Court agreed that "a tortfeasor's mere payment, without more, would not constitute a plan of self-insurance." Baxter, 345 F.3d at 895. Thus, under Baxter, a plan or arrangement must have been developed for a tortfeasor to be considered self-insured within the MSP statute.

The new definition of self-insured under PL 108-173 differs from the one found in *Baxter* by stating that the entity is self-insured if it "carries its own rick (whether by a failure to obtain insurance, or otherwise) in whole or in part." This definition seems not to require the entity to create a plan or arrangement to cover its own liability by including the mere failure to obtain insurance as a means of being self-insured. Under this new definition, if a defendant carried its own risk, in whole or in part for the injuries suffered by plaintiffs, a defendant would be considered self-insured. Thus, Medicare would be entitled to reimbursement for any payment it made to a claimant for personal injuries for which the Defendant is now paying to the claimant because Medicare would be considered the secondary payer of the claimant and the defendant would be the primary payer.

V. Planning Opportunities.

In order to avoid exposure to Medicaid and Social Security, a plaintiff may decide to have her recovery paid into a Special Needs Trust, such as that approved by the Tolbert PCB settlement, attached.

If property damage and personal injury are both available to receive a recovery, the recovery might be allocated to property damage only in the settlement agreement. Examples would be allocating all environmental contamination damages to property and not personal injury or allocating all car wreck damages to the car's damages and not personal injury. Of course, the settlement agreement is only one criterion and is not controlling.