

MONITOR



Frank McKellar
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Our 28th Anniversary Issue A Structured Settlements Q&A with Frank McKellar

Q: *Mr. McKellar, how long have you been working with structured settlements and why did you get into this field?*

A: I started structured settlements on April 1, 1979, which proved to be an auspicious date even though it was April Fool's Day. The reason I developed structured settlements in Canada and worked with the tax authorities at that time was primarily due to my 15 years prior experience working in claims with a large Canadian casualty company. Frequently I would visit plaintiffs to whom I had paid policy limits a year or two before and found they were completely or just about out of money. Some were even on welfare having gone through hundreds of thousands of dollars. I knew there had to be a better way.

Q: *Why did they not have any money left?*

A: I have a saying that just because you have been hit by a bus does not make you a good investor. Even the best educated, most well-informed individual can make investment mistakes. (Nortel and Enron are but two tragic examples!) Many injured parties are subject to questionable investment schemes suggested by well-meaning, as well as not so well-meaning, relatives and friends. They see a large sum of money which appears huge to them and they think it will last forever. We, in the financial industry, know that when you are replacing income and paying for medical care you need a lot of capital to keep the income stream going... especially for life.



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Q: *You must have been exposed to a lot of injured people over the years. How have they generally reacted to having a structured settlement?*

A: Our company has worked with thousands of injured people. Our structured settlements have performed exactly as promised. We have 100% satisfaction with their performance. Our letterhead says, "Billions of dollars invested, not a penny lost.", and that is true. We can also add: "Not a penny taxed."

Q: *I hear that structures are inflexible and if the plaintiff needs to make a large purchase he cannot access the capital. Can you comment on this?*

A: We can be infinitely flexible when establishing the structured settlement. I like to say that we are architects of money. We sit down with the plaintiff and his advisors to work out the best income pattern possible. We also recommend that not all money go into the structured settlement and that the plaintiff keep liquid investments to respond to unforeseen needs. However, at the end of the day there is always a limited amount of money. If the structure does not have \$50,000.00 for a purchase, then the lump sum would not have it either. The lump sum might allow the plaintiff to buy the \$50,000.00 item, but then the plaintiff would run out of income for the other necessities for which he was awarded damages.

Q: *Doesn't the equity market average 7% or 8% over the long-term? Would that be comparable or even better than a structured settlement?*

A: Yes, the equity markets do average that on a taxable basis, but the very word "average" means that some do better and some get substantially mangled. Plaintiffs have zero risk tolerance. They cannot afford to be in the half of the group which performs lower than the average. Furthermore, tax-free structured settlements provide leverage which makes the yield within the structured settlement worth perhaps 1½ to 2 times the actual yield.

For instance, a plaintiff who is in the top tax bracket who is getting a 5% rate of return on a structured settlement is getting the equivalent to a 10% yield taxed at the 50% rate. Even someone who is taxed around 1/3 is getting an equivalent to almost 8% yield and there is no risk in that yield.

Q: *I understand that some plaintiffs' lawyers have been asking for a gross-up to pay the broker's commission so that the plaintiffs get all the damages invested. Can you comment on this?*

A: We strongly disagree with providing a gross-up to pay the broker's commission for several reasons. Some provinces have statutory discount rates (interest rates) for calculating the present value of future income streams. Other provinces use accepted discount rates or those given in evidence which the Court finds reasonable. No matter how you determine the present value of the future income stream, it is understood that the award will be invested in commissionable investments. All investments are. What is the logic which says that you should get the broker's commission added to your award in the case of structured settlements? If you buy your own annuity, you do not get the agent's commission; if you invest mutual funds, you do not get the mutual funds sales person's commission or the ongoing management fees; if you buy Government of Canada bonds you do not get the commission from the defendant.

Where there is future income tax owed the Court will usually allow a gross-up to pay for the tax, but there is no income tax owed for a structured settlement. We must be extremely careful what goes into the structured settlement. Canada Revenue Agency will not allow the plaintiff's own pre-judgment interest which is tax-free to go into the structured settlement without tainting it. If you start putting the broker's commission and other items into the structure you can lose the tax-free status of the payments.



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Q: *Isn't it true that sometimes the plaintiff's lawyer or judge will ask to see the income stream which could be produced with or without commission and the one without commission is higher?*

A: Yes, and so would the mutual fund recovery be higher without commission and management fees. So would the Government of Canada bond pay more without commission. So would GIC's if the banks did not charge commission and profits. Your real-estate would perform better if you did not have to pay any commission. By adding commission in the case of a structure, all you are doing is lowering the discount rate used to calculate the present value. The reason you are lowering that rate is because once you have used the accepted or statutory rate to calculate the present value of a future income stream, you have the dollar value for the purpose of all investments. To then add more money is to add money to a number which already includes commission and other costs.

Q: *What about management fees?*

A: While management fees can be awarded there is a school of thought that says a good investment advisor should generate sufficient income to cover his own fees.

Q: *Has there ever been a default in the payment of a structured settlement?*

A: Not in Canada, and there is never likely to be one.

Q: *What about Confederation Life, which went into liquidation in 1996?*

A: You make a good point. Before Confederation Life, I used to say that there had never been an insolvency of a federally-registered life insurer in the history of Canada. Now I have to say that there has been one. But I can also say that not a penny less than 100¢ on the dollar was paid for any of the insurance benefits. Sure the company's investors lost money, but the Office of the Superintendent of

Financial Institutions (OSFI) moved in and the different components of Confederation Life were sold off to other life insurers which assumed the obligations. This is not a corner store; this is a highly regulated industry. It has an unblemished payment record.

There is an interesting story I like to tell. In the 1930's the Government of Alberta defaulted on one of its bonds and concurrently slashed the interest rate payable on its other outstanding bonds to 50% of the coupon rate. My understanding is that this shortfall was not made up until the 1950's. All during the Depression, the federally-registered life insurers made 100% of their payments. They were viewed as a safe haven for money. People purchased life insurance products during the Depression and older people who lived through that period of time still view life insurers as safe havens.

Q: *What do you see is the future of structured settlements in Canada?*

A: The future is very good. More and more provinces are enacting statutory provisions which allow judges to order structured settlements in specific cases where the plaintiff has substantial financial vulnerability. This is not a paternalistic system; this is a system which really works quite well for injured parties. Although there is only anecdotal evidence that many plaintiffs who receive lump sums end up with no money or even on welfare...it is anecdotal evidence which I have personally observed over my more than 40 years working with the personally injured.

Because of the leverage provided by the tax-free nature of the payments and because the structured settlements bring peace of mind to plaintiffs with guaranteed income, while reducing the cost to the defence and defence insurers, the future for structured settlements appears to be bright in Canada.

Coming soon: The McKellar Minute. This is a periodic e-mail with helpful tips regarding structured settlements. E-mail info@mckellar.com to subscribe!





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