

## **“STRUCTURED SETTLEMENTS 101”**

## **WHAT IS A STRUCTURED SETTLEMENT?**

The structured settlement is a financial package, designed to meet a particular plaintiff's needs. It does this through periodic payments, either for a fixed term or for the plaintiff's life. In addition, the structured settlement usually provides for "up front" money for special damages such as medical expenses, lost wages, special equipment and the usual out-of-pocket expenses. The structured settlement can be tailored to meet most needs that an injured person might have. In that respect, it is more responsive to the plaintiff's particular needs than the conventional lump sum payment.

Perhaps the most obvious benefit of the structured settlement is that all of the payments made pursuant to the scheme are received tax-free in the hands of the injured party. The premise behind the tax status of structured settlements is that such treatment parallels the traditional treatment of a lump sum payment. That is to say, that damages for personal injury or death, being compensatory in nature, have traditionally not attracted income tax. In the structured settlement, one simply substitutes a series of periodic payments for the lump sum payment so that there is no logical reason why the tax treatment should be any different.

The funding vehicle for the structured settlement is generally an annuity. This funding vehicle has been developed over a number of years and has been useful because of its great degree of flexibility which has allowed the design of structured settlements to become quite sophisticated. For example, they can be indexed at a given rate to compensate for inflation and can also be designed to provide lump sum payments at intervals to replace equipment such as wheelchairs and vans, etc. Supplementary income streams can be added from time to time as required.

As well as benefiting injured parties, the structured settlement provides substantial benefits to the defendant's casualty insurer. It is common that casualty companies will want a discount off the conventional lump sum award in exchange for structuring.

## **FEDERAL LEGISLATIVE REQUIREMENTS**

### **REVENUE CANADA - IT-365R2**

Revenue Canada IT-365R2, May 8, 1987, governs the implementation of structured settlements. Section 5 sets out the criteria for structured settlements. The qualifications may be summarized as follows:

1. Damages must be in respect of personal injury or death.
2. The casualty company insurer is obliged to make periodic payments to the injured party.
3. The casualty insurer must buy an annuity.
4. The annuity contract itself must be single premium, non-assignable, non-commutable and non-transferable (please see exception noted below).
5. The contract must respond precisely to the obligations of the casualty insurer.
6. The payments must be irrevocably directed to the plaintiff.
7. The casualty insurer must remain liable for the payments (please see exception noted below).

### **EXCEPTIONS**

4. As of January 29, 1993, the casualty insurer may commute any payments owed to it as a result of a reversionary interest. This only applies in the event of death of the plaintiff, where the casualty insurer is designated as the beneficiary under the structured settlement contract and in the settlement documents.
7. Liability for the structure payments may be assigned to another casualty company (assignee).

## WHEN IS A STRUCTURE APPROPRIATE?

There are a number of categories of cases or fact situations which suggest the use of a structured settlement. These types of cases are indicated by the main areas of benefit provided by the structure, namely:

1. the tax benefit
2. the security or social benefit
3. other

The following is a list of the types of cases where the general benefits referred to above are applicable:

### (i) Fatal Cases

Since awards are based on net or after-tax income in awarding a dependency allowance in fatal cases, and, further, since the case law suggests that a gross-up is appropriate in an amount sufficient to compensate for the payment of future income taxes, then a substantial savings can be realised through the use of a structured settlement. The reason for this is simply that no gross-up need be allowed since the payments made by a structured settlement are tax-free in the hands of the plaintiff.

### (ii) Future Care

The claim for future care is similar to that in the fatal case in that the award or settlement is based on an amount net of income tax. There are some notable differences between the future care claim and the fatal claim insofar as a number of expenses for future care are deductible from taxable income. There is, however, a large group of items falling within the description of future care which, in fact, are not deductible for tax purposes. Allocations in respect of those claims must be grossed-up for tax purposes.

### (iii) Future Loss Of Earnings

The claim for future wage loss can be readily distinguished from either the fatal claim or the future care claim. Whereas in the case of the fatal and future care claims, the award is made on a net, after-tax basis, the award with respect to future loss of earnings is made on a gross or pre-tax basis. It follows that since no deduction is made for future tax payable, then no gross-up need be made in this connection. Since the settlement is premised on a pre-tax amount, a substantial savings can be achieved with the use of a structured settlement since there is no income tax component in the wage loss claim when resolved on the basis of a structured settlement.

It should be noted that, with respect to post-Bill 59 claims, Section 267.10 of the Insurance Act mandates structured settlements in the circumstances prescribed by Ontario Regulation 461/96, Section 6, "Structured Judgments".

It is also interesting to note that Section 267.11(i) of the Insurance Act precludes the inclusion of gross-up on an award against a protected defendant for income loss or loss of earning capacity.

(iv) High Quantum

While the use of a structured settlement is perhaps most obviously advantageous in large settlements for tax reasons, the viability of the structured settlement is not limited to these cases. The tax benefit arising from the structured settlement must be assessed in light of the circumstances of each particular case and, more particularly, with regard to the marginal tax bracket of the recipient. A plaintiff in a high marginal tax bracket, even in a case where the quantum is relatively small, will benefit substantially from a structured settlement. It is this type of case which is most frequently overlooked.

(v) Impaired Lives

Annuity contracts can be written on the basis of an impaired life. Impaired life ratings merely reflect reduced life expectancy. Most injured plaintiffs will qualify for some rating. As the life insurance company issuing the annuity contract expects to make payments for a shorter period of time than it would to a plaintiff whose life expectancy is normal, the effective yield of the annuity is enhanced. This financial leverage is not available in any other investment.

(vi) Excess Limits Claims

Where the funds available from an insurance policy are insufficient to allow the claim to be settled within limits, giving rise to the risk of a Judgment which will place the assets of the insured at risk, the tax and social benefits of the structured settlement can be used to attempt to contain the claim within policy limits. This avoids the risk of a bad faith claim against the insurer.

(vii) Under-Insured Claims

There would appear to be substantial advantage in the plaintiff's insurer working with the defendant's insurer to settle cases where the claim exceeds the limits of the defendant's insurer. For the reasons outlined elsewhere, the structured settlement can be utilized to minimize the contribution necessary. This may involve the joint ownership of annuity contracts by the defendant's and the plaintiff's insurers.

(viii) Court Ordered Structures

Under Section 116 of the Courts of Justice Act, the Court has the discretion to order a structured settlement in a case where the plaintiff claims gross-up for future taxation. This applies to causes of action arising after October 23, 1989. This section, while seldom used in the past, has recently been applied to several notable cases, and it appears that the Court will invoke this section more frequently in the future.

(ix) Minors

The Income Tax Act [paragraph 81(1)(g.1)] protects the minor from taxation on accrual of interest on damages until the age of 21. That protection is applicable only with respect to injuries to the child and does not apply to other causes such as the wrongful death of a parent (i.e. FLA claims). Further, the structured settlement protects the minor from the risk of dissipating funds which he is entitled to claim at age 18 in the conventional settlement.

(x) Financial Mismanagement

There are any number of circumstances in which legitimate issues may arise as regards the ability of a plaintiff properly to manage his money. That concern is particularly acute where the plaintiff will not be able to obtain gainful employment and is, therefore, reliant upon the proceeds of settlement for his support. Indeed, one might question how many people are capable of managing the proceeds of a conventional settlement. Certainly, the statistics suggest that the majority of claimants would benefit from the security of income offered by the structured settlement.

## NEGOTIATING THE STRUCTURE

### INTRODUCTION

It is generally acknowledged that one of the most difficult, yet important aspects of claim settlement is the negotiating process. In the end, everything hinges on the ability to convince the plaintiff, or his lawyer, that the settlement being offered is fair and reasonable and should be accepted. Effective negotiating is, therefore, a major key to achieving satisfactory settlement results.

The advent of structured settlements has created new opportunities and challenges in the negotiation of claim settlements. For this reason, I will offer some practical suggestions on how to strengthen the settlement negotiations when a structured settlement is involved and to discuss approaches which will maximize the benefits of structures.

#### *Approaches to Negotiation*

There are essentially two approaches which can be taken in the negotiation of a structured settlement.

First, one can determine the value of a claim on a conventional basis and then offer a plaintiff the right to structure that amount or, more probably, that amount less a discount for the insurer conferring the right to structure. This recognizes that the structure process confers economic benefit over and above a lump sum settlement.

The second approach is to address the specific needs of the plaintiff as identified in the various expert reports. While this latter approach is preferable from a defence perspective, it is sometimes difficult to achieve a settlement on this basis. A plaintiff or his lawyer will want to know the cost of the structure and compare that to a conventional lump sum assessment to determine whether the offer is reasonable.

It has been our experience that it is very difficult to enter into a negotiation based on the use of the structure where there is not a reasonable level of knowledge on the part of counsel. If negotiations are being conducted directly with the plaintiff, the situation can become even more difficult in that most plaintiffs will have never heard of a structured settlement. They will therefore be very wary of such a proposal, particularly coming from a representative of the defendant.

Generally, once the mechanics and benefits of a structure are explained, resistance by a plaintiff tends to melt away. Timing and approach are important, and are discussed below.

In cases where substantial resistance to a structure is anticipated, it would be beneficial to involve the services of a broker to participate in the settlement discussions. While it is not the broker's function to deal with issues of liability and quantum, a good broker can be very helpful

in convincing a plaintiff that a particular structure being offered is more valuable than a specific lump sum amount which the plaintiff might have had in mind as a settlement objective. As well, the structure broker can be positioned as a neutral party at the negotiating table. As a general rule, most plaintiffs are more likely to give more credibility to the independent structure broker than to the defence representative who is invariably seen as an adversary.

Insurers invariably look for some ways to discount or reduce the amount of a settlement where a structure forms part of the settlement. What discount is appropriate and how does an insurer rationalize the discount? Each case must be judged on its own merits but generally, the following factors should be considered:

- (i) A casualty insurer has no obligation to offer the right to structure and, if willing to do so, should look for a quid pro quo – namely a discount. This is justified by the fact that the insurer bears administrative costs relating to owning the structure and, as well, has the ongoing liability to guarantee the structure payments.
- (ii) Most claims are subject to various negative contingencies which are well recognized by the courts as relating to future economic losses.
- (iii) In accident benefit claim settlements, the relinquishing of a reversionary interest by the insurer would certainly support an argument for a discount.

### ***What Should be the Basis of Negotiation?***

A settlement, to be attractive to a plaintiff, must respond to his needs. Time does not permit the full development of a needs analysis, but suffice it to say, it has been our experience that by designing a structured settlement which responds as precisely as possible to the needs, as indicated by occupational therapists and other experts, we can develop a proposal that would be attractive to a plaintiff. This does not necessarily mean that the case will ultimately be resolved on the basis of that exact structure. It does, however, show the plaintiff that you are attempting to respond to his needs and that the offer is sufficient to do that. Frequently, plaintiffs elect to use the same amount of money as proposed in an illustrative structure to arrange a structure which varies somewhat in exact detail and which they feel is more "custom tailored". Notwithstanding, it is extremely helpful to be able to illustrate to a plaintiff that his needs have been properly looked after particularly where there are ongoing expenses, say for future care needs or where there is a future loss of income.

Predicting future needs by its very nature involves some speculation. Plaintiff counsel sometimes commissions Future Care Reports. Adjusters recognize some of these reports are requested to "up the ante" during negotiations. Adjusters may question the validity of those authors' assumptions. Insurers often look at the extent, frequency and quantum of past accident benefits paid as a more accurate assessment of likely future needs, in conjunction with the consensus of attending health care practitioners.

Example: if today three years post loss, monthly medical expenses are incurred at \$1,500.00, is that not a more accurate projection than a report speculating the need will be \$3,500.00 per month in five years time.

Information as to the plaintiff's needs comes from many sources. For example, occupational therapists, actuaries, economists, rehab specialists as well as various medical reports. It is important to recognize that the structure settlement must respond not only to the needs which are identified, but to the plaintiff's perceived needs or desires which may have little or nothing to do with the litigation.

For example, I can recall being involved in the negotiation of a fairly substantial settlement for an injured teenage boy. We had to work through a number of alternative options, all of which addressed the essential future needs of the plaintiff but which varied somewhat in respect of specific features such as secondary income streams and periodic lump sums. It became apparent only after an hour or so that the plaintiff's father, who was the litigation guardian, had a personal desire for his injured son to be a millionaire. Once this was recognized, I was able to build in a future lump sum in the amount of \$1,000,000.00, but deferred for many years so that the cost of purchasing the lump sum was relatively negligible in comparison to the overall settlement. Once that lump sum was identified in the illustrative printout, the settlement was readily concluded.

What the foregoing demonstrates is that one must pay close attention to the human dynamics of the negotiation process and to attempt to obtain a read on the plaintiff's emotional as well as financial needs.

Another example relates to certain individuals who have difficulty accepting the notion of an annuity in lieu of a lump sum. That is, they have a problem understanding that some unknown financial institution is going to take a substantial part of their lump sum and generally only give them back a monthly income in return. They perceive that they have "lost" their capital. In fact, the capital is returned as a part of each structure payment. However, in order to accommodate people who have this view of structures, it is simply necessary to build in lump sums which equate to the annuity premium. In this way they can readily see that they are receiving their capital back.

Obviously, it is most useful if these more intangible needs of a plaintiff or his representative can be discovered well in advance of the negotiation so that there is sufficient time to develop a proposal which responds to these circumstances and needs.

### ***When Should the Structure be Introduced?***

The simple answer is - the sooner the better.

One must recognize that most individuals are totally unfamiliar with the structured settlement concept and must therefore have sufficient time to be educated in the concept. Time will also give them the opportunity to confer with other advisors such as their bank manager or family accountant to obtain their views. Invariably, these experts will lend their support to the structure.

If a structure is introduced at the last minute, you should expect to encounter greater if not considerable resistance. If plaintiff counsel or indeed the plaintiff, have had insufficient opportunity to properly assess the benefits of a structure, they will be more inclined to reject it out of hand.

In some cases where the prospect of a structure has been left to the 11th hour, a plaintiff has already developed a mindset in relation to the lump sum which he is about to receive as a settlement. He may well have already made plans for various ways to spend the funds. It is then extremely difficult to convert a plaintiff's thinking to accept periodic payments from a structure.

It is also a benefit to introduce a structure concept early, particularly if one is going to attempt settlement on the basis of responding to needs as opposed to using a conventional lump sum assessment to purchase a structure. This is because there is an inherent savings within the structure costing as opposed to undertaking present value calculations on an actuarial basis.

### ***Why Offer a Structured Settlement?***

The answer to this question is very straightforward. You should be structuring to save money. The cost benefits arise from a variety of sources:

1. A discount on the amount that you would have been prepared to pay on a conventional basis. In essence, the fact that you can deliver tax-free payments to the plaintiff justifies the discount from what you would normally have had to pay on a pre-tax basis. In that connection, we routinely prepare what we refer to as a comparison analysis which illustrates clearly to the plaintiff, and those advising him, the magnitude of that benefit;
2. Savings on the build-up of pre-Judgment interest;
3. Savings on defence costs;
4. Savings on plaintiff costs, and;
5. Savings due to timely settlement. The passage of time rarely results in traumatic injury cases becoming any less expensive to settle. Indeed, general inflation and increasing quantum make these cases much more difficult to settle with the passage of time. The structured settlement provides a method of clearly meeting the plaintiff's needs at an acceptable cost.....early.

### ***Who Should be Involved?***

In practical terms, the real question is whether or not the structure broker should be involved in the negotiation process. In some cases this may not be necessary or indeed may not be practical.

In most cases, however, the chances of successfully negotiating a settlement using a structure will be enhanced if a broker is involved.

Some of the key advantages of having a broker participate in the settlement discussions, are as follows:

1. Technical questions can be responded to immediately and accurately;
2. The momentum of negotiation is maintained if issues arise which otherwise could not be answered;
3. Claims adjusters and lawyers are not expected to be experts in structures (and would probably prefer not to give financial advice), and;
4. The structure broker will be viewed as non-adversarial (or at least, as less adversarial).

Further commentary may be helpful.

Like any other form of negotiation, some specialized knowledge of structures is, if not essential, at least helpful. Plaintiff fear and ignorance are the greatest barriers to structuring. It is difficult to imagine a situation in which a defence lawyer or claims person who may not fully understand structure concepts, will be able to educate and convince the plaintiff's lawyer or the plaintiff himself. This is particularly true in the context of the adversarial system where any concept coming from the defence will be perceived by the plaintiff and those advising him as being somewhat suspect. That is to say, most people find it somewhat difficult to accept the proposition that structured settlements are a win - win situation and will assume that since structures are being offered by the defence, that it is somehow to the benefit of the defence, and , therefore, to the detriment of the plaintiff.

It is in these circumstances where the services of a structure broker can be very useful. We are perceived by plaintiffs and those representing them as being somewhat less adversarial.

Frequently, we are introduced to the process either by the claims person or by a defence lawyer. Once the idea of a structured settlement has been propounded, the defence might say to plaintiff counsel or the plaintiff that they are going to have a structure broker contact them to talk about the suitability of a structure in the case at hand.

Having the opportunity to meet with the plaintiff or plaintiff's counsel can be extremely valuable. It is very doubtful that, during the course of negotiations, plaintiff counsel will admit to a lack of understanding of the structure concept, particularly in the presence of his client. On the other hand, plaintiff counsel do not feel nearly so threatened in dealing directly with a structure broker.

### ***How to Overcome Plaintiff Resistance***

There are a number of factors which we have identified which give rise to resistance in the use of a structured settlement and in general terms, these factors may be identified as follows:

1. Fear and ignorance;
2. Inappropriate form of structured settlement;
3. Inappropriate allocation of funds as between up-front money and the structured settlement;
4. Late introduction of the structured settlement concept, or;
5. Improper presentation of the structured settlement offer or proposal.

The form of the structured settlement has already been addressed, but in general the structured settlement which appears to respond to the needs of the plaintiff has the best prospects of contributing to the settlement of the action. Those needs may arise from the cause of action but they may also arise out of the claimant's background and values. It is useful to keep in mind those factors which arise from sources other than the cause of action.

Insofar as the allocation of funds is concerned, it has been our experience that some amount of up-front money is usually required, depending on the family's financial resources. It is important that money be available to cover contingencies during the plaintiff's minority years and until the structure payments begin.

The need for the early introduction of the structure concept has already been discussed. Few plaintiffs will react favourably if they perceive that a structured settlement is being foisted upon them at the eleventh hour. This situation can be avoided by suggesting the structure in the very early stages of negotiation, or even before.

One feature that can enhance the presentation of a structure is some sort of comparison analysis which compares the structure to a conventional investment. This can demonstrate very simply and clearly that the plaintiff is much better off taking a structure as opposed to a conventional lump sum. Such comparisons are prepared by the structure broker.

In summary, structured settlements clearly offer a "win-win" settlement for plaintiffs and defendants. The benefits to each side, however, can best be maximized by introducing the structured concept and involving the structure broker as early as possible.