

Maximizing the Settlement Money

The Advantages and Disadvantages of Structured Settlements

By: Charles E. Gluckstein, J.D. , LL.B.
Gluckstein & Associates

Maximizing the Settlement Money

Executive Summary:

“More important than the investment products ultimately selected by the client is the process that is used to design the plan and financially prepare the client for today, tomorrow and the years to come.”

In the first section the advantages and disadvantages of structured settlements are discussed. The key advantage to a structured settlement is the provision for a guaranteed and tax free income. However, a primary concern with structured settlements is that at the end of the guarantee period, or the death of the client, whichever is later, the insurance company that agrees to the structure could become the ultimate beneficiary of any funds remaining in the plan if a reversion clause is forced into the Settlement minutes. In other words, the insurance company your client sued to obtain their settlement is the ultimate beneficiary of those funds. Alternatively, if the client invests a lump sum settlement, he or she can designate a beneficiary.

The second section defines an investment process that should be engaged by clients who receive settlements. The income required by the client cannot be sacrificed. The goal of any settlement investment plan is to establish the proper balance between inflation and capital protection. A carefully established plan, which considers the clients investment time horizon, income requirements and past financial experience, can bring these two conflicting risks into balance.

The final section discusses the impact of taxes on an investment program. While an investment program is taxable, there are four points to remember about investment income tax. First, a significant portion of the income from the settlement plan is simply a return of capital and is therefore not taxable. Second, there are tax credits available that, if utilized, could minimize the impact of tax on an annual basis. Third, an investment portfolio does not necessarily attract tax on all of the gains it earns each year, a portion of those taxes can be deferred for many years. Finally, any income earned on a settlement for an infant is tax free until age 21. Thoughtful tax planning, including the use of all applicable tax credits, can minimize the tax burden while maximizing the growth of the investment portfolio.

In summary, the ideas in this paper represent an alternative for managing settlement proceeds. The structured settlement has been the best option to date for providing settlement income. While the structured settlement remains a good option for some clients, many people could benefit from the flexibility, control and potential for improved returns with the type of customized investment program I have created.

Maximizing the Settlement Money

I would like to thank you all for inviting me to speak at your conference today. Over the course of the next 20 - 25 minutes we will be discussing a number of issues surrounding the management of settlement proceeds from personal injury litigation. I will be outlining a process that should be engaged in order for you to ensure your client's settlement funds will be managed properly for as long as the client needs that source of income. I know how hard you work to obtain fair settlements for your clients and part of your role includes helping your client establish an appropriate plan for managing those funds. These settlements can be an excellent source of cash flow for your clients if managed properly, or they can just vanish if they are mismanaged. The structured settlement has conventionally been the primary option for placing the funds, however, with increased competition and flexibility in the financial services industry, specialized financial advisors help create a customized wealth management program to complement the structured settlement or replace it entirely.

Before we consider investment management and some options available to clients, I would like to review structured settlements, how they can be beneficial to your client and where they fall short. We will then look at the process I work with when assessing a new client's needs and we will consider some of the various investment programs available for your clients. Finally, I will present 2 case studies to illustrate the points we have discussed. Together, these elements will define the investment process clients should engage for funds that are either ineligible for a structure or are left outside the structure.

Structured Settlements:

OTLA Medical Malpractice Conference, London Ont. January 15, 1999 (revised 99/08/09)

Maximizing the Settlement Money

I would like to preface this discussion by saying that in many circumstances the structured settlement is the best program to place settlement funds - a structure will provide a guaranteed cash flow to your client who might never have any source of income other than the structure again. Structuring all of the settlement money may be beneficial for a client who is not capable of making sound financial decisions. Given today's low interest rates however, it costs the client a considerable amount of money in terms of the volume of settlement capital required to fund a reasonable monthly cash flow.

There are three primary advantages to buying a structured settlement. First and foremost is the guaranteed cash flow. Depending on the program selected, your client can obtain a guaranteed cash flow for life, or a program that has a 2% indexing factor worked in to pay until age 65, or a high level payment for 20 years etc. etc. Your clients get a tremendous sense of security by knowing on the first of every month they will get an income cheque, guaranteed.

The tax free status of the cash flow is the second main advantage of the structured settlement.¹ The tax free yield creates the opportunity to evaluate the quoted rate objectively against what is available in the market. If you assume that the tax free status is simply a rate quoted in after tax dollars, then you can calculate the comparable pre-tax yield. Depending on your client's marginal tax rate, this tax free status will add an additional 40% - 50% onto the yield of the structure. Therefore, if you are quoted at an effective rate of 3% - in reality your

¹ For an explanation of why structured settlements provide tax free cash flow to the client, please see Revenue Canada IT Bulletin IT-365R2, May 8, 1987.

OTLA Medical Malpractice Conference, London Ont. January 15, 1999 (revised 99/08/09)

Maximizing the Settlement Money

client is earning about 5% in pre-tax interest, roughly the current yield on a guaranteed, longer term provincial utility bond.²

This brings us to an important concept, that of indifference. Indifference is an idea that emerges in economics and has particular relevance in comparing investments with each other. All *rates* being equal, a fixed income investor with all of the information about GIC yields available to Canadians should not have any preference in selecting a 5 year GIC. If all rates were the same, the investor would be indifferent to where his or her money was placed - the safety is the same, the return is the same, the maturity date is the same and the date of issue is the same. The investor is neither ahead nor behind by selecting any of the GIC products to which he has access. This concept of indifference is relevant for comparing structured settlement yields to non-structured settlement yields because if there is an after-tax advantage to an alternative investment program, then where would you advise your client to place their money? Indifference should lead a settlement recipient to the investment option that offers the highest return with the lowest risk and the most flexibility the client can properly manage.

The third key benefit of the structure is that the risk to the insurance company of providing the cash flow to the client must be reinsured. In many instances, a structured settlement can have a pay period for 40 or 50 years. In that period significant change in the insurance industry can take place. The reinsurance requirement protects the client against insolvency or other changes to the status of the insurer. While virtually no policy holders lost any money with the collapse of Confederation Life, the reinsurance requirement would have protected the client completely.

² Current is defined as early January, 1999.

OTLA Medical Malpractice Conference, London Ont. January 15, 1999 (revised 99/08/09)

Maximizing the Settlement Money

As with any financial program, the benefits of structured settlements have their associated costs and I will now outline the costs and weigh them against the benefits I just described. The primary concern of the structured settlement is that the capital is completely inaccessible to the client. Structured settlements are completely inflexible and do not provide any access to the capital in the event of a catastrophe or a change in the tax laws that make investing outside of the structure as tax efficient as inside. The client never has the opportunity to access the capital or re-negotiate the rates. The money that is used to establish the structured settlement cannot be assigned for a loan, nor can it be accessed in the event of a financial emergency or other extenuating circumstance. Let's consider the situation of a baby who loses oxygen to the brain in the delivery process and suffers brain damage as a result:

You successfully prove negligence on the part of the attending physician. You obtain a two million dollar settlement for the baby that is designed to pay future care costs and also to pay for tuition to a special school at a later point in time. The client purchases two structured annuities in an effort to meet the child's future needs.

The first annuity will begin payment immediately for twenty four hour nursing care. The second annuity is a deferred annuity with a ten year deferral to take care of education costs and medical expenses that are expected to increase over time. In this case, the defendant assigns the payment liability to a life insurance company and buys two structured settlements.

Maximizing the Settlement Money

The client (actually the injured person's parents) purchased the annuities because of the tax free status. What they failed to realize was any income earned on the settlement until the end of the year in which the child turns 21 is tax free anyway. In order to save tax today (which they could do in any event), they gave up the ability to have any access to the capital should their child require it.

In situations involving compromised babies, indifference should lead the parents to consider alternatives to structured settlements. If the parents elect to hold the money in trust for the child's benefit and then invest the capital in a portfolio of provincial government bonds and investment grade preferred shares with a comparable yield to a structured settlement, where is the client better off? Assuming the yield after all management fees (which can be tax deductible - more important after age 21) is the same and assuming the credit quality of the preferred share issuer is the same as that of the annuity carrier, then the credit rating is the same, the impact of tax is the same (to age 21 - after age 21, it is my contention that the capital, if used and invested properly, can grow sufficiently to mitigate the impact of tax after age 21) then the choice is now between a program with absolutely no flexibility or growth and one with a tremendous amount of flexibility and an opportunity for growth.

A flexible investment program in this instance would provide the parents with the ability to respond to changes in the child's situation. By establishing an investment plan and

Maximizing the Settlement Money

taking advantage of the tax free status of any income earned on a settlement for personal injury to age 21, the clients might be better off than by electing for a structured settlement.

The second concern I have with structured settlements is that by assigning the settlement to the insurance company forever, the client relinquishes any opportunity to participate in the profitable investment of that money. While the settlement is designed to replace lost income today and in the future, it is likely that the settlement funds could be more profitably invested and enhance the wealth of the client. Of the money placed in a structured settlement, the client will never receive anything more than the contracted cash flow. On the other hand, if the client invests in an investment portfolio, he or she can participate in the profitable investment of their capital and potentially have more money. Moreover, because it is possible for clients to invest in the equity markets and be protected from any capital losses over time, clients should very carefully consider the economic benefit of the structured settlement.

Finally, the third concern I have with structured settlements is that the client's estate is NOT the beneficiary of any capital remaining in a structured settlement. Some annuity contracts will provide, for example, a guaranteed payment period of twenty years. Should your client pass away in year seven, the estate will receive the cash flow for the remaining 12 + years. This can be a tragedy if there are dependents that are not provided for. Consider the following example:

Your client is a widowed mother who is 32 years old and received a multi-million dollar settlement that resulted from a surgeon's error in an elective procedure. Her husband, who was a successful computer company executive, died as a result of the doctor's negligence. At the

Maximizing the Settlement Money

time of the surgery, the couple did not know the wife had just conceived their first child. The economic result to the family is that the husband, who was the sole income earner could no longer provide for his wife and their unborn child. On resolution of the settlement the widow, in consultation with her attorney, decided to buy a structured annuity because it would provide her a guaranteed and indexed income stream. It was purchased as a life annuity with a guaranteed pay period of twenty years.

The annuity was designed to pay a lot now, index for the next 25 years and then as it is predicted the child will be becoming self sufficient, the cash flow will cut back again to reflect the anticipated lower monthly costs for the widow. Unfortunately, the mother died of natural causes three years after the plan was created, and the child's only source of income is going to end at age 20. In the program that was created, the child was not adequately provided for. This solution was appropriate for the child only if the mother lived. There was no provision for an estate to be left behind in the event of the mother's early death.

The premise behind this solution is clear and is also readily accepted in court: replace the income of the person who died. However, this does not mean it was an adequate solution for both the widow and her child. The widow didn't work before her husband's death and her prospects for employment were even lower following her husband's death. From a tax perspective, she has very little annual income and could have

Maximizing the Settlement Money

taken advantage of many of the tax credits her accountant discussed with her. In other words, she wasn't at risk of paying too much in tax if she did not use a structured settlement. Furthermore, from an estate planning perspective, her child was inadequately provided for. The guarantee period on the annuity was scheduled to end at about the same time the child would be entering his first year of post secondary education. In this situation, the risks to all parties were not sufficiently considered. The guarantee period on the structured settlement was accepted because it adequately compensated the widow for her loss, but it will economically destroy her son. A better alternative would have been to combine a tax efficient investment program or structured settlement with a tax exempt life insurance policy with the child named as the irrevocable beneficiary. This would have resulted in protecting the son from the biggest economic risk he faces - the premature loss of his mother that would result in the contracted termination of his sole source of income.

Now that we have considered some of the benefits and concerns of the structured settlement, we can turn our attention to investment management and helping your clients find a suitable alternative or complement to a structured settlement. It is important to remember that no two clients have exactly the same needs, risk tolerance and tax situation. An investment advisor that specializes in investing settlement funds can provide flexible and appropriate investment solutions that are customized to your client's needs. In order for us to determine how we can best aid your client, we need to work with a clearly defined process. For the next several

Maximizing the Settlement Money

minutes, I would like to discuss the process I use to understand the needs of your clients and determine an appropriate investment solution.

Investment Process:

I suspect that the first time a parent comes to you to talk about a tragic mistake in the neonatal i.c.u. or a mistake during a routine surgery that leaves the client a quadriplegic, there are a number of questions you want answered - what happened, why the baby was in i.c.u. or why the client was undergoing surgery, how old is the client, who the doctor was and who the staff were. I suspect you would also want to know why the parents came to see you, what they thought you could do for them, where they work, what they earn, where they live, how many other children they have or was this their only child. All this information is vital in determining if there is a valid argument in this file and if you are properly suited to handle it. The first interview will tell you if you have a case or not and what resources you will have to allocate to it.

What I do is very similar - of course the questions I ask are likely very different but the goal is the same - we want to know as many details as possible about the client's situation and how we can create a program that will best suit the client today and provide a flexible solution for tomorrow. In particular, we want to know about the client's income needs and their expenses. It is imperative to know about the future cost of care and an appropriate indexing factor on those costs. It is also important to know where the client can obtain tax credits. For those under the age of 21 any income earned on a settlement is tax free, for some the disability tax credit might be an option and for others, deductions based on their medical expenses might provide the most relief from tax. The client's previous experience with money is particularly relevant to the settlement investment program I might recommend. Are they mortgage free, do

Maximizing the Settlement Money

they have RRSP's and if so, how are they invested, did they establish a 3 - 6 month emergency fund? Do they have any income producing properties, have they been active in the stock market before? Are they self employed or are they employees, are they savers or spenders, are they bitter and angry about their injury?

The answers to these questions are very revealing about a client's ability to handle the settlement and whether or not it will be around forever or if it will dissipate quickly with very little to show for it. The client will tell us how they and their settlement will be best protected. In some cases the rigidity of the structured settlement is the best option. In others, a formal legal trust with a corporate trustee might best protect the client, or the client might have the ability to properly manage the settlement with the help of an investment professional. In looking at the cases I have worked on over the past year, I have come to realize that while the settlement capital can be substantial, for the most part it does not make the client rich. The settlements I have seen are designed to maintain the standard of living that was in existence prior to the injury. In order for that objective to be reached a properly managed program is essential.

Included in the information I need is an understanding of the client's estate planning needs and objectives, and a preliminary understanding of where the estate assets are. Does the client have young children that should be beneficiaries of the settlement proceeds, is the client an injured baby who will likely rely on the proceeds from the settlement for another 50 or 60 years. Are there other risks that the client faces that would be best if we could transfer them to someone else? When all of this information is compiled and taken together with the investment experience and financial profile, I will itemize the client's answers and provide a summary of the investment goals, time horizon, tax situation and risk tolerance in a document called an

Maximizing the Settlement Money

Investment Policy Statement. The Investment Policy Statement sets the framework for the resulting investment program and it establishes the guidelines for an ongoing relationship with the client. One of the benefits I bring to my clients is that I do have ongoing contact with them in order to ensure the plans we create still reflect their needs and goals. Since an investment program is flexible in nature, we can make any necessary changes if need be.

In general, there are two components to an investment portfolio - the portion that provides cash flow and guaranteed returns and the money that is targeted for growth.³ When I am building a portfolio for someone who is building their net worth, we will manage these two types of money in the same account. For a client who receives a settlement and depends on those funds for income, or is retired for that matter, it is far more appropriate to segregate the income account from the investment account. If I provide for the required cash flow two, three or five years in advance of when it will actually be paid, the client will be protected from movements in the market. Within the investment account, the client will have some of their funds invested for guaranteed returns and some invested for growth. This is done based on portfolio theory and the ideas that emerged from the Brinson study of the early 1990's. (see note 3)

Cash Flow Account

In most cases the cash flow account will run on a 5 year basis, although with larger cash flow requirements and larger settlements, we may look to create a 2 year cash flow account. The amount of money that goes into the portfolio is the present value of the monthly cash flows as calculated by real returns available in the market at the time of investment. The purpose of this

³ Brinson Study, 1990. - The authors of the study polled several American institutional money managers and reviewed the performance of their portfolios and developed some interesting conclusions. Essentially, they found that the returns a portfolio earns are more dependent on the asset allocation - the proportion of money in stocks, bonds and cash - than the returns of a single investment in a single security. Thus, careful planning must go into the determination of the asset allocation in the portfolio.

OTLA Medical Malpractice Conference, London Ont. January 15, 1999 (revised 99/08/09)

Maximizing the Settlement Money

cash flow strategy is to put the client in control of their monthly income. By being proactive about cash flow, we can minimize the impact of volatility in the investment account.

The bonds I use are a special type of fixed income investment that do not provide a regular cash flow. Instead, the investor pays \$90 today for a \$100 maturity in, for example, 3 years. The benefit of these bonds is there is actually more money available for investing in the investment account than if we financed the cash through interest bearing notes. If the client requires \$100000 over the next two years, by buying this type of bond, it might cost them \$90000 to get that maturity. Essentially, there is an additional \$10000 to invest for growth over the next two years. Typically, I will buy bonds issued by the Government of Canada, the provinces or some of the provincial utilities. Those debtors are some of the most stable issuers of debt in the country and the risk of default is negligible. I will typically time the bonds to mature as close to the time it will be distributed as possible, for some clients this might mean we mature bonds monthly, for others quarterly and for others semi-annually or even annually. If their bonds mature early, the client will be paid interest for cash that is on deposit in their account and that cash deposit has similar guarantees to the cash on deposit in a regular bank account.

Growth Portfolio:

Whereas the cash flow account is established to provide a monthly income to the client, the growth portfolio is typically where most of the client's money will be placed. The purposes of the growth portfolio can vary from client to client. In some cases it might be to finance periodic purchases that would not be covered by a structured settlement's cash flow, in others it might be to finance a monthly cash flow program as described above, or it might be designed to pick up the cash flow from a structured settlement in 20 years, when the structure terminates.

Maximizing the Settlement Money

As mentioned above, the growth portfolio is created with a longer time horizon than the cash flow account and is invested with an appropriate allocation between stocks, bonds and cash as determined by the client's needs, time horizon and risk tolerance. Where appropriate, the client will pass the day to day management of the funds to professional money managers (we can do this through a variety of programs including mutual funds, segregated funds and professionally managed discretionary investment programs) and allow the managers discretion in selecting the specific investment securities. The investment policy statement will establish the guidelines for managing the money and it will create an investment mandate for the manager to adhere to. The selection of investment programs is based on the client's needs and the best available information at the time of investment. Generally, failure to comply with the Investment Policy Statement or perform will result in immediate termination of the manager and selection of a new manager. It is important to note that the specific selection of investment managers and programs will vary among clients. We can select among programs that have unique guarantees and those that have tax deductible management fees.

Conclusion:

Over the last decade there has been a significant transformation in the financial services industry and there are a variety of investment options available to people who receive insurance settlements from personal injury or medical malpractice litigation. Each client has a unique risk / reward profile, tax situation and cash flow requirement. For some clients it is clear that a structured settlement is the only program that will meet their demands, for many others a blend between the structured settlement and an investment program will meet their needs and some clients will benefit from having all of their money invested in an investment portfolio. The key

Maximizing the Settlement Money

to successful management of the funds is hiring an advisor who can help the client evaluate the benefits of a variety of financial programs, not just one type of investment, and select the very best program that reflects the unique concerns of the individual families involved. Clients are entitled to the settlements they receive and the settlement capital should be managed accordingly.

Maximizing the Settlement Money

Works Cited

Evensky, Harold. Wealth Management: The Financial Advisor's Guide to Investing and Managing Client Assets. McGraw Hill, New York, 1997.

Graham, Benjamin and David Dodd. Security Analysis. Whittlesey House, New York, 1934.

Graham, Benjamin. The Intelligent Investor. (4th revised edition) Harper Collins Publishers Inc. New York, 1973.

Hatch, James E. and Michael J. Robinson, Investment Management in Canada. (2nd ed.) Prentice Hall. Scarborough, 1989.

O'Shaughnessy, James P. What Works on Wall Street. McGraw Hill. New York, 1997.