

Making Sense of Time Value of Money and Agency Considerations in Structuring Legal Settlements in Canada

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In countries following common law practices, courts award compensatory or punitive damages to aggrieved plaintiffs in civil trials. Given the growing litigious nature of the public, many parties on the defending side have lobbied for caps to be placed on these settlements as they may be quite large. Courts rely on expert witnesses, such as actuaries and time value of money experts, to provide a quantum of the damages, which will either be paid in a lump sum upfront or spread out over a finite period. On the opposite side are lawyers representing the plaintiff arguing against caps in advocating on behalf of victims. This paper examines the issues associated with the structuring of these settlements from a financial perspective.

INTRODUCTION

In common law countries, courts have awarded damages either compensatory or punitive for aggrieved plaintiffs in civil law trials. While many of these trials are settled out of court and their settlements are often not disclosed and removed from the public domain, there are still a significant number which make it to court. Given the growing litigious nature of the public, many parties have lobbied for caps to be placed on these settlements, as many of them have become quite large. Courts rely on expert witnesses, often actuaries and time value of money experts, to estimate damages which will either be paid upfront or spread out over a significant time period. On the opposite side in the litigation will be the lawyers who represent the plaintiff, often arguing against caps and advocating for the rights of victims. This paper examines the issues associated with the structuring of these settlements from a financial perspective leaving the resolution of legal issues to a different audience.

For the past three decades tort settlements have provided long-term financial security to victims and their families (Koenig, 2007), as well as serving a critical role in settling personal physical injury or physical sickness and, in less common cases, such as for workers' compensation claims (Risk, 2001).

A tort is defined as an incident that causes someone else to suffer loss or experience harm, which results in a legal liability for the person who had committed the act (Williams & Smith, 2002). In any tort case, legal injuries are not limited to physical injuries but can include emotional, economic, or even damages to reputation (Williams & Smith, 2002). Torts are not criminal offenses; these cases differ in that

torts may result from negligent behaviour, as well as intentional criminal intent. Lawsuits for tort cases have a lower burden of proof (Williams & Smith, 2002), which means that a verdict is determined by a preponderance of evidences (balance of probabilities), rather than beyond the reasonable doubt requirement in a criminal case. There are examples of plaintiffs receiving an award in a civil case, even after being acquitted in an earlier criminal trial. A notable example of this would be O.J. Simpson, who was acquitted in criminal court of murder, but was found liable in the subsequent wrongful death case.

STEPS IN A SETTLEMENT

Tort lawsuits that lead to a settlement have a variety of steps, most of which commonly occur in any type of lawsuit. These steps may transpire in a different order depending on the specifics of the case. A civil case may begin with a statement of claim being filed with the court and can involve a long process of evidence and expert opinion gathering. A lawsuit of sufficient size can take years to be settled or go to trial. Due to the long period of claim settlements, negotiated settlements are fairly common. In fact, more than 95% of car accident cases are settled out of court (Himelfarb, n.d.).

The first step in any claim is gathering facts and evidence to support a claim. The victim and the lawyer will gather witness statements, police reports, and other supporting documentation. This process generally can continue over the course of the lawsuit.

The second step (if not already done) is filing a statement of claim. The court will date and make copies of the statement, which will be delivered to the defendant. After this step, the lawyers on both sides have the opportunity to make specific requests for a court order. These requests can include proceedings concerning how the lawsuit is handled. Once fact gathering has concluded, the discovery process begins. During this time, the respective lawyers may question the plaintiff/victim and defendant under oath. In the case of permanent injuries, medical exams are common. A physician or physicians, surgeons or psychiatrists will be selected and their findings will be used as part of the case, as well as in the actuarial report. During these steps, and up until the time of trial, both sides make specific promises to one another called 'undertakings' (Himelfarb, n.d.). Undertakings relate to the exchange of information necessary to the case. This would include the actuarial report, medical, and employment information. Once a significant amount of evidence has been gathered, the lawyer will likely consider the legal ramifications of the facts and give an updated opinion of how the trial may be resolved, what the outcome will be, or how large a settlement can be expected.

During the case, the victim and defendant's lawyer(s) may try to settle the claim out of court. This can happen at any point prior to the judge's final decision. Should the trial not be settled in negotiations, it will go to trial, and the case will typically be decided several days to weeks after the trial hearing period concludes.

When a settlement is awarded, these damages can be delineated into two main categories: pecuniary and non-pecuniary damages. The pecuniary damages, which can also be known as 'special damages', are those that can be monetarily measured as loss of past and future earnings, medical, and care costs. Non-pecuniary damages or 'general damages' are those that cannot readily be measured in dollars. These damages are included in a tort settlement to compensate an injured person for pain, suffering, or disfigurement.

Structured settlements have experienced popularity among court rulings in tort cases for a variety of different reasons, not the least of which are the income tax-free payments and guaranteed income for life. The tax-free damage payment for a person's physical injury or physical sickness claim or a worker's compensation claim is extended not just the money paid in settlement from the releasing party, but to the future growth of that money, while it is in possession of the releasing party responsible for making future payments (Risk, 2001). As an example, if payments are deferred, all the internal growth of the annuity is paid out to the claimant, free of any income tax obligation. However, should the claimant exercise the right to take the whole value of the sum in a lump payment, that lump sum is tax-free; however, any subsequent money earned on the lump sum is taxable, whereas the growth/income in the structure

settlement continues to be tax free. So, in a structured settlement, by taking a structured payment schedule, income tax is avoided on the future payments (Risk, 2001).

“The Court does not restrict itself to awarding damages for non-pecuniary loss in cases concerning bereavement damage.” (Rijnhout & Emaus 2014, 2)

There has been recorded legal precedence in both American and European court cases where they do not limit the damages that can be claimed on non-pecuniary damages, such as bereavement. Many articles on European law, including the European Court of Human Rights, comment on the awarding of non-pecuniary damages is part of the compensation for the violation of human rights.

While settlements, particularly those in structured formats, provide future security, there is a cap on non-pecuniary damages (Garrow & Ayre, 2009). Placing a cap on awards for pain and suffering may violate the rights of the victim. In terms of a settlement, the goal is to provide justice to the victim of an accident that led to a permanent injury. In this way, settlements are designed to effectively consider the future earnings; however, by placing a cap on non-pecuniary awards, such as pain and suffering, the victim's restitution is limited, because their maximum possible outcome is limited. Indeed, this is a difficult aspect of a settlement to consider; in the case of permanent physical injuries, how much can one value walking a daughter down the aisle?

STRUCTURED SETTLEMENTS AS FUTURE SECURITY

An annuity, like a structured settlement, can guarantee that the money will not be exhausted during the payee's lifetime. A structured settlement is a “settlement in which the defendant agrees to pay periodic sums to the plaintiff for a specified time” (Black's Law Dictionary, p. 1337). Based on actuarial reports, a sum of losses net of taxes is calculated to the retirement age (assumed to be 67, based on the Labour Force Survey Data (2011)). Calculations of loss are made assuming an absence of contingency of unemployment, meaning that the losses are considered pay from the same company since the time of the accident. Within that company, “real” wage increases are not considered. Real wage increases are increases in wages in excess of inflationary increases. Additionally, interest rates on past losses are calculated on a simple, rather than compound, basis. Finally, a net discount rate is used to calculate present value and future losses due. These must take into account the investment wealth earned in both capital sums, as well as investment income. A usual standard is a Government of Canada Bond, which provides yields of 0.8% to 2.59% per annum, with higher yields for longer terms.

A necessary consideration of a structured settlement, and why an actuarial report is so important, is inflation. The impact of inflation must be accounted for in the settlement, as it is expected that future payments would need to keep pace with inflation in order to maintain the value of the settlement to the victim. According to the 2017 actuarial report, inflation has averaged about 1.5% per annum. The calculation of inflation is conducted indirectly by using the “net rate of inflation” which represents the difference between future interest rates and the expected future inflation rates, also known as the “real” rate of return.

An important part of the settlement is the determination of value loss of future earnings and if they must be considered on a net basis, meaning after income tax, Canada Pension Plan (CPP) contributions and Employment Insurance (EI) premiums. In this case, it would necessitate a gross-up to prevent the loss of future earnings for the plaintiff. This is necessary to protect the plaintiff from the tax liability of the future investment earnings on the capital sum awarded for the loss. The size of the gross-up depends on the amount of the award made to the plaintiff, other future damage costs, as well as other taxable income that they are currently receiving or expect to receive in the future. In the case that a structured settlement is reached between the parties, the payments would flow through to the plaintiff on a tax-free basis, thus eliminating the need for a gross-up.

In the assumptions of the actuarial report, the life expectancy of the victim is estimated based on past medical history, and injuries due to the accident. It accounts for the mortality rate across the various demographic cohorts for all Canadians. This is necessary as a part of a structured settlement when

considering long term care costs for the victim. Additionally, these costs can also be included in a gross-up.

STRUCTURED SETTLEMENT CAPS

Structured settlements are designed to provide security to the victim of an accident who, in the absence of a settlement, may be unable to have a standard of living equivalent to before their injury. However, the non-pecuniary damages component of the settlement makes this a hard concept to quantify. As mentioned previously, non-pecuniary damages are those not readily associated with a dollar amount. They have to do with pain and suffering, disfigurement, and many other components of damages that the victim may have suffered but did not provide a billable charge.

In 1978, Canada's cap on non-pecuniary damages became law as a result of a trilogy of cases by the Supreme Court in *Andrews v. Grand & Toy Alberta Ltd*, *Teno v. Arnold*, and *Thorton v. Prince George School District No. 57* (Garrow & Ayre, 2009).

The current cap on non-pecuniary damages in Canada is \$371,795 as of August 2017 (McKeller, 2017). This cap provides obvious limitations in terms of the philosophical underpinnings on which structured settlements were developed: to restore the position that the victim would have been in if no loss had been incurred. As demonstrated previously, and borne out through several court cases, there are quantifiable ways to determine aspects of value from a pecuniary perspective, using multipliers and current salary projections with discount rates applied. However, caps on pain and suffering were established, even in the absence of a quantifiable method to determine the value of a victim's pain and suffering.

The reasoning behind the application of caps in this regard was due to a variety of concerns, not the least of which was that, in the most severe of cases, non-pecuniary damages is virtually limitless and could lead to extravagant and inconsistent awards (Smitiuch, 2017). However, among the consideration of caps on non-pecuniary losses was the claim that non-pecuniary losses are not genuinely compensatory as no money can provide true restitution for the pain and suffering experienced.

From this perspective, it could be argued that the plaintiff being fully compensated for the future losses of income and future care costs is more important than the non-pecuniary damages. However, this begs the question surrounding settlements. It would seem fairly apparent that in a structured settlement, with an accurate actuarial report, and compensation for current wages at future values for the life of the victim that includes allowances for investments, that the current settlement structure is sufficient to provide compensation for their financial losses. However, the current cap on non-pecuniary damages has been criticized with requests for review in recent years. Many cases have shown awards above the cap amount for non-pecuniary damages.

AGENCY ISSUES THAT ARISE FROM CAPS ON NON-PECUNIARY DAMAGES

Litigation generally views the attorney as an agent of the client (Miller, 1987). The attorney's responsibility is to represent the best interests of the client in a lawsuit. There are a variety of sanctions that enforce this, including the potential for a breach of contract suit (Miller, 1987). The attorney has an equity interest in the litigation from the plaintiff, offering services in exchange for a percentage of the recovery. In this agreement, referred to as a contingency fee agreement, the attorney is the agent of the plaintiff, enforcing the plaintiff's part of the claim. However, it is also important to realize that the attorney is also acting as a principal for their own gain with respect to the litigation (Miller, 1987). Agency problems may abound in these suits.

In a capped settlement system, where the upside for attorneys is limited by the cap, this creates a stark agency issue for the plaintiff due to the dual role that their attorney assumes. This means that the interests of the plaintiff and the attorney are likely never perfectly aligned (Miller, 1987). The cap system in settlements makes this an even more notable gap between agent and principal desired outcomes, as the upside for the attorney as principal is limited. Additionally, where settlements in regard to long-term

injuries are concerned, the litigation process is protracted into weeks and often months. As a result, the time cost to the attorney becomes exceedingly great. In this case, the attorney may be influenced to settle on an agreement that would provide them a desirable outcome, but would not be most beneficial for the victim (Miller, 1987).

The legal system has claimed to resolve this problem by leaving the power of acceptance, ultimately to the plaintiff (Miller, 1987). However, this is not an ideal solution, due to the high level of social influence shared in the client-attorney relationship. The attorney, acting as principal, may counteract themselves as agent by influencing the client to settle for a quick, lump-sum outcome that the attorney can quickly benefit from without the additional time investment.

The argument with regard to caps on non-pecuniary damages in this case is one of resolving the agency issues between the client and attorney. In a non-capped settlement system, the potential payout for a lawyer working on a contingency basis is far greater. This could mitigate the many instances of attorney's attempting to encourage a settlement for their client in the hopes of a lump sum payout, due to the coupled pecuniary and non-pecuniary payouts being sufficiently great.

ISSUES IN UNDERSTANDING SETTLEMENT IMPLICATIONS

Settlements for permanent injuries frequently are very large, in the millions of dollars. However, this has been shown to pose problems to victims, especially to those who elect for a lump-sum payment. Statistics indicate that approximately 30% of settlements that are paid in a lump-sum are exhausted within two months. Within five years, that number rises sharply to 90% (Andrada, 2000). The reason is that the victims of these settlements are typically unaccustomed to handling large sums of money (Hindert & Ulman, 1981). As a result, structured settlements are a necessary part of financial security in large payment sums that are meant to be granted as restitution for a victim's livelihood.

This underlines an issue with fund management, as most people need help dealing with such a significant windfall that is meant to last them the rest of their lives. This is another reason that structured settlements have become popular in court settlements; it allows the victim to deal with a familiar amount of funding on a regular basis, rather than a lump-sum settlement, which can be destructive to the victim.

However, this has been shown not to be an ideal solution for many. In many cases factoring companies have made cash offers at deep discounts for the future payments of a structured settlement in exchange for money today. These organizations prey on a settlement recipient's current need for money and undermine their future security. Legal structures have attempted to limit this action by proposing a 40% excise tax on any purchase of settlement annuity that does not have a court approval; however, there is significant legal evidence to show that the courts are very lenient to approval as long as the recipient of the claim can justify the expense and is in favor of the transaction (Risk, 2001).

In this manner, it can be assumed that the only reason to sell future security for present value would be a demand for money in the short term. In this way, caps on non-pecuniary damages create a barrier for individuals in realizing their future security which makes tort victims more vulnerable to the tactics of factoring companies and, therefore, lowering their overall return, thereby compromising the purpose of the settlement, the victim's future security.

Finally, it is unlikely that the victims understand the meaning of the settlement beyond a nominal sense. Projecting need and risk into the future are well documented as issues concerning human cognition (Kahenman & Tverksy, 1979). Given this, a structured settlement is seemingly destined to be sold to a factoring company due to a person's lack of consideration of future risk. In this particular manner, factoring companies are using the bias outlined in prospect theory and the principals of time value of money against tort victims in order to capitalize on structured settlements. In this case, the tort victim can be easily influenced into agreeing to a sale of their future earnings at a deep discount. It is clear that a more stringent protection of victim's security is necessary.

RE-EXAMINING THE CAP ON NON-PECUNIARY DAMAGES

On April 20, 2017, in Brantford, Ontario, a jury awarded an injured plaintiff over \$2.4 million in damages after a five-week trial (Smitiuch, 2017). Included in this award was \$600,000 for pain and suffering, otherwise known as non-pecuniary damages, nearly 40 years after the cap was imposed by the Supreme Court of Canada. This award has concentrated debate on the cap of non-pecuniary damages and whether or not it should be re-examined.

The case behind re-examining the cap comes from the imposition of valuation to the plaintiff's pain and suffering and while the idea of moderating the awards to circumstance of which there is no objective yardstick, those who are very severely injured can, and do, perceive this as a grave injustice (Smitiuch, 2017). The requirement established by the Supreme Court in the Andrews case stated that any award must be "fair and reasonable". In the McKnight case, although the plaintiff's injuries were less serious than someone rendered a quadriplegic, the impact on the quality of life was assumed to be significant enough to merit the \$600,000 award.

Indeed, the judicial system is correct when discussing the rationale for the cap on non-pecuniary awards - the awards are not compensatory. No amount of money will make up for the losses suffered by a victim of such severe injuries; however, it is just as important that the victim receives justice for the injuries. In this way, the financial rewards can be seen as simply restoring their earnings that they would have had in the absence of the event that led to their injuries. However, the pain and suffering experienced could be seen as a significant burden; therefore, by capping the result, the courts may be understating the victim's true compensation, both financial and psychological.

In truth, the cap on settlements for non-pecuniary damages still allows the victim to experience distributive justice (Adams, 1965). Through the procedure of the courts, they acquire an award that allows them to recover their lost earnings in the accident. However, absent from the consideration on caps is the idea of restorative justice (Braithwaite, 1999). Under the principle of restorative justice, a victim will seek some form of restitution to restore the way it might have been.

For many, the loss of the ability to live their lives in the manner that they could or that they would choose is the most traumatic part about being injured (Smitiuch, 2017). Putting a cap on structured settlements denies a victim of a crucial piece of their restitution; that of restorative justice and this, arguably, is the most significant piece.

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