

New York 50A and 50B Case Resolution

This is another update in the continuing saga of 10-Year Treasuries. As the 10-year daily yields seem to have gained universal acceptance as the "...rate in effect on the date of the verdict", or the base discount rate not only for amended 50A, but also original 50A and 50B cases, the recent movement of daily yields is of considerable importance.

The following is a listing of daily yields for the 27 business days since the beginning of the year until the current auction results announcement.

01/01/2009, ND 01/02/2009, 2.46 01/05/2009, 2.49 01/06/2009, 2.51 01/07/2009, 2.52 01/08/2009, 2.47
01/09/2009, 2.43 01/12/2009, 2.34 01/13/2009, 2.33 01/14/2009, 2.24 01/15/2009, 2.23 01/16/2009, 2.36
01/19/2009, ND 01/20/2009, 2.40 01/21/2009, 2.56 01/22/2009, 2.62 01/23/2009, 2.65 01/26/2009, 2.70
01/27/2009, 2.59 01/28/2009, 2.71 01/29/2009, 2.87 01/30/2009, 2.87 02/02/2009, 2.76 02/03/2009, 2.89
02/04/2009, 2.95 02/05/2009, 2.95 02/06/2009, 3.05 02/09/2009, 3.07 02/10/2009, 2.90

The yields have shown a general rising trend, and that movement raises two related questions, what caused the change and will it continue. The movement may be a reflection of a cooling of the flight to safety or a movement in anticipation of the current regular 10-Year Auction. With the results of the regular quarterly auction now recorded (the actual auction precedes the settlement date on or after the 15th of the month), it may offer an indication of how the Treasury markets rate the movement.

- The latest regular auction in February has a stated rate of 2.75%, and a yield of 2.818% or the government will receive \$99.41 for every \$100 bond value.
- The previous regular auction in November had a stated rate of 3.75%, and a yield of 3.78% or the government received \$99.73 for every \$100 bond value.
- The first interim auction had a stated rate of 3.75%, and a yield of 2.67% or the government received \$109.35 for every \$100 bond value.
- The second interim auction had a stated rate of 3.75%, and a yield of 2.419% or the government received \$111.58 for every \$100 bond value.

The stated rate is what the government expects to pay in interest for each note issue, and it may change with each regular auction. The auction yield is what those who purchase Treasury notes at auction expect the government to pay in interest on each note issue as determined by the price paid for the note. The spread between rate and yield may be an indication of the direction and size of the expected movement that the Treasury market anticipates. For regular auctions, the yields are consistently above the rates and may reflect a buyer's profit. The average spread in the last 23 auctions has been .7%, with a range of .3 to 1.2%. The latest regular auction spread is .7%, or no clear indication of short term uncertainty, nor any strong expectation that yields will not settle in the current range of 2.45 to 2.95% for some time.

Impact on Valuation and Cash

If movement within this range remains true, the Award after discounting and application of the statutory inflation factor, but before Collateral offset, expenses and fees will be larger than the original Award after allocation of lump sums. The cash breakeven yield is 3.625% for elements with future payment periods of 20 years or less, and 2.925% for elements with future payment periods of 30 years (the difference arises from the application of 2% points above the 10-year Treasury).

Whatever the case, the continued softness of and fluctuations in daily yields, together with their use in discounting future Awards and lump sums just complicates the process of gaining resolution of settlements and verdicts.

The first and most prominent complication is the daily yield itself. The range in the listing of daily yields above is 2.23% to 3.07% or a difference of .77%. If you use a rule of thumb that when future damages are spread

somewhat evenly over 30 years, the valuation of the total Award is likely to be 7.5% higher at 2.23% versus 3.07%. In essence, a good part of the valuation is determined by the day the verdict is returned.

The other complications include;

- **Higher valuation of future damage Awards as yields decline.**

- Using our model, the difference in discounted valuation of future loss elements between 2.45% and 2.95% is 6.5% under 50B, 6.2% under original 50A, and under Amended 50A 4.8% for future elements and 5.3% for lump sums where those lump sums are determined by discounting 35% of the Award element.
- Both yields are below the 3.625% breakeven point for elements with payment periods of 20 years or less, and the higher yield point is only slightly above the 2.925% breakeven yield for elements with payment periods of 30 years. That means that the Award after statutory inflation and discounting but before application of Collateral Source offsets is greater than the Award after application of lump sums but before application of statutory inflation and discounting.

Award after Application of inflation and discounting vs. Award after allocation of Lump Sums

	<u>@2.45%</u>	<u>@2.95%</u>
• Under 50B	11.46% more	3.93% more
• Under Original 50A	10.60% more	3.89% more

- **Amended 50A.** Statutory inflation is applied only to Pain and Suffering and only the award for that element increases in value. 2.45% produces an increase of 4.27%, and 2.95% produces an increase of 2.24%.

- In the current market, the actual annuity cost is likely to be significantly lower than the valuation. This decouples attorney fees from the actual advantage to the plaintiff, as the fee is based on the net valuation, and the advantage may be the sum of the annuity costs. (Under Amended 50A, the plaintiff shares in 35% of the advantage for those items where the lump sum is determined by discounting that 35%.)
- The Structured Settlement Protection Act provides that the defendant disclose in writing the terms of any structured settlement including the amount of the premium payable to the annuity issuer. There seems to be some precedent that plaintiff's attorney could be held liable to the plaintiff for any failure to disclose the true cost for an annuity when the attorney is aware of that true cost. Since the statute does not specify whether or how the difference between valuation and annuity cost will be resolved, it leaves any resolution with the trial judge.

[Over time, it is likely that the annuity providers will raise their prices to more closely match the valuation.]

- Interest is designed to compensate the plaintiff for any delays in resolving the case and initiating payments. Post-verdict interest is applied to the total Award including net future damages. The question is whether that includes the net discounted future damages Award or the cost of annuities.

- **Lower overall returns when total future payments are divided by higher valuations.**

- Future payments are determined independent of discount rate, but the values are discount dependent. The discount rate is, under ordinary circumstances, the Internal Rate of Return or the imputed interest rate. The overall return for an annuity payment stream is the total payment stream divided by the cost or the amount surrendered by the plaintiff to gain the annuity. It is that overall return which determines the amount that would otherwise be taxable.

- The statutes specify that initial future payments are determined by dividing the undiscounted Award less lump sum adjustments by the period over which the payments are to be made. The resulting initial payment amounts are then reduced by application of litigation expense rates and then attorney fee rates.
 - For original 50A and 50B, the resulting initial payment is increased by 4% inflation for each year after the first.
 - For Amended 50A, only the resulting payments for Pain and Suffering are increased by 4% inflation for each year after the first.

If the future value is reduced by a Collateral Source offset then the payments should be reduced by the Collateral Source payments.

[As an aside, the Court of Appeals seems to have endorsed the use of an expected COLA or inflation in determining future Collateral Source offset payments. For Amended 50A, Net future Award payments to which Collateral Source offsets relate will decline over the period of future loss or the period of the Collateral Source whichever is shorter.]

- The individual elements of future loss have different overall returns for the same rate depending on the period of future payments.
 - At 2.45%, the overall return is at or below 10% for items with terms of 10 years or less, 25% or less for items with terms of 20 years or less, and 65 to 75% for periods of 30 years or more.
 - At 2.95%, the overall return is in the mid-teens for items with terms of 10 years or less, 20 to 25% for items with terms of 20 years or less, and 80 to 90% for periods of 30 years or more.
 - Under amended 50A, only Pain and Suffering is impacted with statutory inflation. Since neither the payments nor the valuation contain statutory inflation, overall returns remain in ranges similar to original 50A.
- At these discount rates, the tax advantage on items with future payment periods of less than 25 years are mostly marginal, and the advantages decline as the future payment periods decline.

[The possibility exists that, in the event of a sale of some portion of a future Award, taxable gain might be measured from the lower annuity cost and either produce or increase a taxable event.]

This is an awfully confusing array of complications, and may seem to be more than anyone needs to know. Fortunately, there are only six things that plaintiffs' attorneys need focus upon. They are

- The Cash value of the total Award.
- Whether and when resolution can be achieved.
- Which loss elements should be taken as cash and which should be held as annuities.
- Whether any Collateral Source offsets and/or taxes should be applied.
- Whether interest should be applied to the award and on what basis.
- How the cash proceeds should be deployed and protected.

An independent advisor should be able to address the mechanics of Award development, valuation, and the application of interest and the basis for application. Support and Resources (Attachment A.) sets out system capabilities to address plaintiffs' attorneys needs.

Resolution Proposals

In the current 'financial crisis', liability carriers are not immune from large portfolio losses. In response, their natural instinct is to conserve assets and delay settlements. But, they must still conduct business in an orderly manner and display good faith in resolving cases. With lower discount rates, the liability carriers are likely to pay more to resolve their cases, even if only in plaintiffs' attorney fees. In the end, the liability carriers may well be whipsawed by rising costs and declining returns.

Annuity providers, both independent and parts of larger insurer conglomerates, are also not immune from large portfolio losses. They are probably in the 'whip saw' of high, historical fixed payment costs covered by a portfolio with declining returns. This increases pressure to raise premiums and/or to move further into higher risk investments.

Many liability carriers rely on annuity brokers for their Award valuations, and those brokers would be well aware of the large net valuations associated with lower discount rates, and recognize that their commissions are larger at lower discount rates. They are likely to be under pressure for increasing premiums from annuity providers. In the very short term, the liability carrier will likely be able to place annuities at much lower costs than the element's valuation.

Instead of allowing the liability carriers the luxury of delay, plaintiffs' attorneys should take an aggressive approach and add the complication of a bargain settlement price indexed to some average 10-Year Treasury rate. In this way, the liability carrier will be faced with the risk that delay in settlement may produce an index rate that is lower, and a settlement that is larger.

The interesting thing about auction rates and yields is that when there is a very large disconnection, as the regular February auction rate declined 1 percentage point and the yield declined .962 percentage points from the regular November auction, the disconnection remains in the auction market for some time. That means that even as rates and yields rise, the averages will continue to decline. This means that even in an environment of improving daily yields, a current offer based on an average will be better than a resolution based on a daily yield or some new average based on near term future auctions.

The last two regular auctions yielded an array of averages. In each case, the results were both unweighted and weighted at a premium of 50% per year. There are three periods covered (all regular auctions since passage of Amended 50A, two years and one year). Updates are incorporated in periods between regular auctions.

November 15				Weighted		
	<u>Rate</u>	<u>Yield</u>	<u>Update</u>	<u>Rate</u>	<u>Yield</u>	<u>Update</u>
All Years	4.35%	4.42%		4.33%	4.41%	
2 Year	4.27%	4.35%		4.13%	4.22%	
1 Year	3.91%	4.00%		3.89%	3.98%	

February 17				Wgted		
	<u>Rate</u>	<u>Yield</u>	<u>Update</u>	<u>Rate</u>	<u>Yield</u>	<u>Update</u>
All	4.25%	4.32%		4.16%	4.23%	
2 Year	3.92%	4.01%		3.72%	3.80%	
1 Year	3.60%	3.65%		3.47%	3.52%	

If the one year weighted yield were chosen, The results versus the top and bottom of the range would be

- Original 50A -The total cash out would be 10.4% less than @2.45% and 5.7% less than @2.95%
- Amended 50A -The total cash out would be 7.5% less than @2.45% and 4.0% less than @2.95%
- 50B - The total cash out would be 11.3% less than @2.45% and 5.95% less than @2.95%

The aggressive approach should leave little room for unresolved issues and delays. It should be

- A. Up to date
- B. Incorporate all of the elements of loss including offsets and adjustments
- C. Employ some average discount rate/yield rather than current yield
- D. Incorporate interest, as appropriate,
- E. Select elements for cash and for annuities
- F. Set a date specific for settlement.

The New York 50A, Amended 50A and 50B systems provide

- Detailed Award Work-ups including
 - Both a simple and complex projection of wages and compensation.
 - Inclusion of income taxes, as appropriate.
 - Inclusion of Collateral Source offsets, as appropriate.
 - Automatic updating as future damages, taxes and Collateral Source offsets are converted to past damages.
 - Special Treatment of Med/Mal Wrongful Death Claims
- Detailed Development of Valuations, including
 - Inclusion of income taxes, as appropriate.
 - Inclusion of Collateral Source offsets, as appropriate.
 - Automatic Allocation of lump sums.
 - Automatic Application of discount rates indexed to 10-Year Treasury notes or selection of different rates for different elements
 - Automatic calculation and application of litigation expense rates.
 - Automatic application of the sliding statutory scale in Med/Mal cases or a selected rate.

Award Reports

- Award Summaries that list the components for each element, the calculation of the total Award, and the allocation of Award, taxes and Collateral Sources between past and future.
- A full array of future lost or impaired earnings that incorporates expected increases by decade, commissions, bonuses and other compensation, and adjustments to compensation for obviated non-taxable employment expenses.

Valuation Reports

- A Summary Valuation that tracks the statute element by element and accommodates taxes on lost or impaired earnings as appropriate, applies lump sum calculations, incorporates Collateral Source offsets, lists and applies litigation expense and contingent fee rates, provides net discounted Award and initial monthly payments by element.
 - In the event that interest is to be applied to an Award, provide summarize
 - Pre-verdict interest, together with the discounted value as specified by statute and case decision.
 - Pre-Judgment interest, and
 - Pre-payment interest.

Reconciliation Reports

- A detailed reconciliation from the Award to the net valuation by element. The element Award after application of past damages is then reduced by
 - Taxes on Lost or Impaired Earnings, as appropriate
 - Components of Lump Sums
 - Amounts lost to discounting (Amended 50A)
 - Lump sum amount net of allocated expenses and fees
 - Allocation of litigation expenses to lump sums
 - Allocation of contingent fee to lump sums.
 - Producing a Net Award by element prior to discounting (This amount will agree with the element's net future damages on the Summary).
- Application of discount rate to produce a discounted Award prior to adjustments
- Allocation of litigation expenses to the discounted Award
- Allocation of the contingent fee to the discounted Award

- Application of any discounted future Collateral Source offset

- Producing a Net Award by element that again agrees with the Summary.
- The elements are totaled by category or Pain and Suffering, Medical Expenses and Economic Loss. The categories are totaled into adjusted Award and discounted Award those agree with Future Damages on the Summary.
- Individual adjustments to the discounted Award are then totaled and added back to Net Discounted Award.
- Individual adjustments to the Award are then totaled and added back to the total Future Award to arrive at a Gross Total Award which should also agree with Total All on the Summary.
- Next the expected cash-out is detailed by item.
- Finally, if Award development has been employed, the components of past damages, taxes and offsets are listed and totaled. Again, this should agree with Past Damages on the Summary.

Payment Reports

Schedules list payment information by element and offset by year.

- Monthly payments by year. Inflation is applied as provided in the statutes.
- Annual payments by year. Inflation is applied as provided in the statutes.
- Annual discounted values. The total by element will agree with the Net Award by element on the Reconciliation and the Summary, as long as Collateral Source offsets are not applied against the element.

Incidental Reports

The reports section contains an option for altering variables that affect the discounted value. They are

- Change 10-Year Treasury Note rates or yields, or substitute a single discount rate.
- Change the first payment date. The statute specifies that the first payment date is the date of the verdict, -0- days. Selection of a delayed first payment date will reduce the future Award valuation.
- Change Tax rates for lost or Impaired Earnings.
- Add or remove Collateral Source offsets
- Impact tax costs for Collateral Source offsets that apply to Lost or Impaired Earnings
- Reduce impact of Collateral Source offset for Expense and Fee rates.

The impact of the changes can be displayed on the Summary. They changes can also be shown on a side by side comparison that permits up to five variations. If one set of alternatives is selected and recorded, the other valuation reports become available.

The system will calculate average auction rates and yields, weighted rates and yields, and updated average and updated weighted average auction yields for market changes since the last regular auction. The report shows the individual regular auction rates and yields, and the components of the update, weighting by rate and yield and calculation of all available averages.

Overall Return on Element Costs. A variation of the Annual Payments schedule provides overall returns for each element, together with an evaluation of a trust alternative for making payments and a comprehensive proposal for investing cash proceeds.

