

## New York 50A and B Award and Valuation 2<sup>nd</sup> Strategic Update

At the last update in November, we thought that the flight to the safety of 10-Year Treasuries and the resulting precipitous fall in Treasury yields might continue for a while, but would not sink below the discount breakeven level. That was before the infusion of TARP funds, further reduction in Fed target rates, and the declarations of the Fed that they would take all the steps necessary to ensure liquidity in the marketplace. Mortgage rates declined, but with little effect on the sale of houses.

These created a new round of demand for 10-Year Treasury notes, a marked decline in daily yields well below the discount breakeven level, and the prospect that these conditions would continue for some time. Some now claim that if Treasuries move up too fast, mortgage rates will rise and affordability will decline.

The breakeven discount rate is that point where the future Award after deduction of Lump Sums but before application of statutory inflation is less than the future discounted Award after application of statutory inflation. For future periods of 20 years or less for items with 4% statutory inflation, the breakeven discount level or 10-Year yield/rate is 3.625%. For future periods of approximately 30 Years, the breakeven is achieved at a 10-Year yield/rate of 2.93%.

As the financial crisis deepened, and the flight to safety continued and deepened, the downward movement in 10-Year Treasury rates/yields have been enormous, and they can be summarized as

The daily yield went below 3.625% on three occasions in October, with a low of 3.48%, and on eight occasions in November, with a low of 2.93%. The daily yield has been below breakeven for every business day since November 17th, starting on the 18<sup>th</sup> at 3.53% and bottoming at 2.08% on the 18<sup>th</sup> of December. A display of daily yield information for the last four months is as follows;

	<u>Sept.</u>	<u>Oct.</u>	<u>Nov.</u>	<u>Dec.</u>
Top Yield	3.88%	4.08%	3.96%	2.77%
Bottom Yield	3.41%	3.48%	2.93%	2.08%
Mid-range	3.65%	3.78%	3.45%	2.43%

In the regular November auction, the stated rate for the 10-Year was 3.75% with a yield at auction of 3.78%, and while the December interim auction rate remained the same as in November, the yield at auction was 2.67%.

When the Federal Reserve announced that they would take all steps necessary to infuse and maintain liquidity in the market, the daily 10-Year Treasury yields fell from 2.5+% to below 2.20%.

### Comparison of Different Index Rates on Awards and Cash Payments

The best way to display the impact of different discount rates is to compare the same valuation models using different 10-Year Treasury rates, how they affect future damage Awards, and the Total Cash Payout ( net discounted future damages, net lump sums and past damages, allocated litigation expenses and attorney fees). The effect on valuation can be seen in the Amended 50A, Original 50A and 50B models that are valued at a base rate of 4.22% and then at 2.20%. The Impact of Rate Changes (Attachment A) can be summarized as follows;

<u>Elements</u>	<u>Amended 50A</u>	<u>% Incr/(Dec.) Original 50A</u>	<u>50B</u>
Net Future Losses	21.31%	28.23%	29.53%
Total Cash Payout	15.34%	22.35%	25.10%
Net Award v. Total Award	(22.92%)	10.02%	11.46%

In other words, the valuation of future Award elements and total payout increase markedly as the discount rate drops. When the rate declines below the discount breakeven level, the discounted Award after statutory inflation of 4% but before allocated expenses and attorney fees is greater than the undiscounted element Award after allocation of lump sums. At an index rate of 2.2%, The Net Award or cash payout exceeds the Total Award by more than 10% under original 50A and 50B valuations. Clearly, this would be an unintended consequence of using discount rates indexed to the 10-Year Treasury.

In the short term, the amount of the Net future losses may not represent the amount that the defendant must pay for an annuity. That premium may initially be closer to or above the net future losses at the base rate of 4.22%. In any case, The Structured Settlement Protection Act requires that the defendant disclose the premium amounts, and it is a small step to compare the Net Element Award Valuation and the premium paid. There is no further instruction in the statute as to how that information will be used.

During that period, these disparities will continue,

- Litigation Expense allocation and Attorney fees are based on the element discounted Award, not annuity premiums and, as to attorney fees, they will increase approximately 14% in the amended 50A scenario, approximately 20% in the original 50A scenario and approximately 25% in the 50B scenario.
- Under Amended 50A, for those elements where lump sums are the discounted value of a percentage of the Award element, the net lump sums will increase approximately 21% in line with the increase in the value of the Net Future Losses.
- The value of Collateral Source offsets will also increase with the decline in discount rates.
- Finally, interest will be applied on the total Award, not some combination of Award elements and annuity premiums.

As the 'financial crisis' continues, annuity providers will be under increasing pressure to raise premiums on new business. Their portfolios have been adversely affected like, and perhaps worse than, other insurance carriers, and they are probably in the 'whip saw' of high, historical fixed payment costs covered by a portfolio with declining returns. Theoretically, the liability carriers will be caught in the bind of paying more for annuities.

In any case, the cost of annuities will rise toward the net discounted Award amount and the Total Return based on the providers cost will move below 20%, and come in line with the plaintiffs' low return. The Total return is the total stream of payments less the premium paid or net discounted amount divided the premium paid or net discounted amount.

The expectation that discounting would not reduce the Award after the application of statutory inflation is clearly not consistent with legislative intent, nor is the confusion about the treatment of different components of the Award.

For a considerable period of time we have proposed the use of some average of auction rates/yields as "the rate in effect" at any given time. These have the dual advantages of stability and predictability. They would also reduce or remove the internal inconsistencies that arise from use of daily yields that are below breakeven.

The following table is a summary of auction rates/yields since passage of Amended 50A in 2003. It includes the December 15 interim auction under the update. The detail appears on the rate certificates that are part of our valuation system. The weighting is factored at .5 (oldest rate/yields weight is 1, next oldest 1.5, next 2.0 etc.) to give greatest emphasis to the more recent auctions.

December 15	<b>Weighted</b>					
	<u>Rate</u>	<u>Yield</u>	<u>Update</u>	<u>Rate</u>	<u>Yield</u>	<u>Update</u>
All Years	4.32%	4.39%	4.32%	4.28%	4.36%	4.22%
2 Year	4.16%	4.25%	3.99%	4.02%	4.10%	3.77%
1 Year	3.78%	3.85%	3.62%	3.81%	3.88%	3.47

The 2-Year weighted, updated yield of 3.77% was chosen as an alternative to 2.20%. The effect on valuation can be seen in the Amended 50A, Original 50A and 50B models that are valued at a base rate of 4.22% and then at 3.77%. The Impact of Rate Changes (Attachment B) can be summarized as follows;

Elements	Amended 50A	% Incr/(Dec.) Original 50A	50B
Net Future Losses	4.16%	5.39%	5.63%
Total Cash Payout	2.29%	4.27%	4.78%
Net Award v. Total Award	(31.17%)	(6.24%)	(6.65%)

- As to attorney fees, they will increase approximately 2.5% in the amended 50A scenario, approximately 4.0% in the original 50A scenario and approximately 5.0% in the 50B scenario.
- Under Amended 50A, those elements where lump sums are the discounted value of a percentage of the Award element, the net lump sums will increase approximately 4% in line with the increase in the value of the Net Future Losses.

Liability carriers are in a new world of competing pressures.

- They have sustained losses as their portfolio values have collapsed.
- They are attempting to conserve assets by delaying settlements.
- They must still conduct business in an orderly manner.

Any proposal that compromises the claim by offering to use a higher discount rate should receive a positive response. But, before that can be done, plaintiff's attorney must get the client's informed consent. Discount rates and their application are difficult to understand in the abstract. They can best be explained through an actual valuation or comparison of valuations at different rates.

The same may also be true for defendants that are offered settlements at higher discount rates.

### Overall Return on Investment

As mentioned before, the discount rate determines the return provided by the stream of annuity payments on elements of future loss. The primary impact is on cost, or the element's net discounted value. The overall return for any element is nothing more than the stream of future payments, less the element's discounted value divided by the elements discounted value.

The overall return percentage can be looked at as that part of any payment that would be taxable if the principle was amortized uniformly over the payment period. The tax benefit is the overall return times an effective tax rate. More effectively, the Internal Rate of Return (IRR) can be multiplied by 1 plus the effective tax rate to yield a tax exempt rate of return. The IRR matches the index rate for elements with a payment period of 20 year or less if the future payments are not adjusted for Collateral Source offsets.

The imputed tax exempt returns would be

Elements with	up to 20 Yr Payout	30 Year payout
	2.2% X (1 + .3) or 2.86%	2.86% X (1 + .3) or 3.718%
	3.77% X (1 + .3) or 4.90%	4.44% X (1 + .3) or 5.768%
	4.22% X (1 + .3) or 5.486%	4.887X (1+.3) or 6.353%

The 2008 average yield on tax exempt municipal securities was 4.86%. As the risk in municipal securities rose at the end of the year the yield went above 5.5%. The 2008 average pretax yield on AAA bonds was 5.64%.

It is often easier to look at the overall return as it incorporates the period over which payments are made. The following is a set of guidelines for determining whether plaintiff should follow a cash and invest strategy for any elements of future loss. The investment vehicle would be a post-settlement trust the proceeds of which would ordinarily be taxable.

- If the return percentage is less than 20%, the recipient is gaining little more than the money invested
- If the return percentage is less than 30%, the gain is not as much as a normal return on AAA and Baa bonds, even after taxes.
- If the return is less than 40%, the return is a push, slightly better or slightly worse depending on the investment vehicle, costs for administering the trust and whether tax deductible expenses are funded.
- If beyond 60 or 70 percent, the tax deductibility associated with annuity payments would produce an advantage.

Attachment C. lists the total return by element of future loss at the three 10-Year Treasury Index rates of 2.2%, 3.77% and 4.22% using the provisions of Amended 50A, Original 50A and 50B

### **Strategic Approach to Resolution**

For some time now we have been recommending a strategic approach to resolution of personal injury actions under New York 50A, and personal injury and wrongful death actions under New York 50B. That approach can be summarized as follows;

- Plaintiff should present a full Award including, as appropriate, any taxes on lost or impaired earnings and collateral source offsets.
- Plaintiff should discount the Award using a discount rate indexed to some average 10-Year Treasury rate/yield, and apply interest, as appropriate.
- Plaintiff should select among the elements of annuitized future loss that would provide only marginal returns, and place those elements in a trust that invests in taxable bonds. Past Pain and Suffering, Lump Sums and interest could also be incorporated into the trust res.

Adoption of the 10-Year yield on the date of the verdict has plunged verdict/settlement valuation into a daily yield morass, and the recent collapse in 10-Year daily yields has made indexing to some average 10-Year rate/yield far more compelling.

**Attachment A \_\_\_\_\_ Impact of Index Rates on Awards**

**A 4.22% base vs. 2.20%**

We took similar models and ran them through our systems using a 4.22% 10-Year Treasury rate (the original model rate and the update all years weighted auction yield) and the 2.20% December 17<sup>th</sup> daily yield. The impact can best be seen by comparing total Cash Payout at the two discount rates and total Award to the total Cash payout at the lower discount rate.

**Cash Payout.** The payout is the sum of Net Discounted Award, litigation expenses and attorney fees. The decline in index rate from 4.22% to 2.20% produced an increase in payout of 15.34% under Amended 50A, 22.35% under original 50A and 25.10% under 50B.

**Total Award to the Total Cash Payout** or the net effect of discounting at 2.2%. This produced a reduction from the total Award of 22.92% under Amended 50A, an increase over the Award of 10.02% under original 50A and 11.46% under 50B.

	<u>Amended 50A</u>	<u>Original 50A</u>	<u>NY 50B</u>
<b>Total Award</b>	\$16,916,540	\$16,916,540	\$20,447,485
<b><u>Cash Award</u></b>			
Net Future Damage Award	\$4,983,209	\$10,936,405	\$10,958,036
Net Lump and past	\$5,072,816	\$2,634,636	\$1,872,423
Contingent Fees	\$1,257,064	\$1,647,621	\$5,394,861
Expenses	\$235,000	\$235,000	\$235,000
Collateral Source Offsets	(\$242,450)	(\$242,450)	(\$242,450)
<b>Total Cash Payout at 4.22%</b>	<b>\$11,305,639</b>	<b>\$15,211,212</b>	<b>\$18,217,870</b>
<b>Discount Rate</b>	2.20%	2.20%	2.20%
<b><u>Cash Award</u></b>			
Net Future Damage Award	\$6,044,998	\$14,023,714	\$14,194,147
Net Lump and past	\$5,611,649	\$2,647,691	\$1,877,332
Contingent Fees	\$1,430,469	\$1,987,664	\$6,766,737
Expenses	\$235,000	\$235,000	\$235,000
Collateral Source Offsets	(\$282,426)	(\$282,426)	(\$282,426)
<b>Total Cash Payout</b>	<b>\$13,039,690</b>	<b>\$18,611,643</b>	<b>\$22,790,790</b>
Incr/(Dec) Net Future vs 4.22%	\$1,021,813	\$3,047,333	\$3,196,135
% Incr/(Dec)	21.31%	28.23%	29.53%
Incr/(Dec) Cash from 4.22%	\$1,734,051	\$3,400,431	\$4,572,920
% Incr/(Dec)	15.34%	22.35%	25.10%
Cash Payout vs. Award	(\$3,876,850)	\$1,695,103	\$2,343,305
% Difference	-22.92%	10.02%	11.46%

**Attachment B \_\_\_\_\_ Impact of Index Rates on Awards**

**A 4.22% base vs. 3.77%**

**Cash Payout.** The payout is the sum of Net Discounted Award, litigation expenses and attorney fees. The decline in index rate from 4.22% to 3.77% produced an increase in payout of 00.77% under Amended 50A, 2.62% under original 50A and 3.70% under 50B.

**Total Award to the Total Cash Payout** or the net effect of discounting at 3.77%. This produced a reduction from the total Award of 31.17% under Amended 50A, of 6.24% under original 50A and 6.65% under 50B.

	<u>Amended 50A</u>	<u>Original 50A</u>	<u>NY 50B</u>
<b>Total Award</b>	\$16,916,540	\$16,916,540	\$20,447,485
<b><u>Cash Award</u></b>			
Net Furue Damage Award	\$4,983,209	\$10,936,405	\$10,958,036
Net Lump and past	\$5,072,816	\$2,634,636	\$1,872,423
Contingent Fees	\$1,257,064	\$1,647,621	\$5,394,861
Expenses	\$235,000	\$235,000	\$235,000
Collateral Source Offsets	(\$242,450)	(\$242,450)	(\$242,450)
<b>Total Cash Payout at 4.22%</b>	<b>\$11,305,639</b>	<b>\$15,211,212</b>	<b>\$18,217,870</b>
<b>Discount Rate</b>	3.77%	3.77%	3.77%
<b><u>Cash Award</u></b>			
Net Furue Damage Award	\$5,190,410	\$11,525,908	\$11,574,491
Net Lump and past	\$5,177,516	\$2,637,571	\$1,873,539
Contingent Fees	\$1,290,814	\$1,712,541	\$5,656,042
Expenses	\$235,000	\$235,000	\$235,000
Collateral Source Offsets	(\$250,599)	(\$250,599)	(\$250,599)
<b>Total Cash Payout</b>	<b>\$11,643,141</b>	<b>\$15,860,421</b>	<b>\$19,088,473</b>
Incr/(Dec) Net Future vs 4.22%	\$199,052	\$581,354	\$608,306
% Incr/(Dec)	4.16%	5.39%	5.63%
Incr/(Dec) Cash from 4.22%	\$337,502	\$649,209	\$870,603
% Incr/(Dec)	2.99%	4.27%	4.78%
Cash Payout vs. Award	(\$5,273,399)	(\$1,056,119)	(\$1,359,012)
% Difference	-31.17%	-6.24%	-6.65%

**Attachment C. Total Return on Annuities Covering Future Damage Awards**

	<u>Period</u>		<u>Return</u>	<u>Return</u>	<u>Return</u>
	Yrs	Mos	<u>4.22%</u>	<u>3.77%</u>	<u>2.20%</u>
<b><u>Amended 50A Elements</u></b>					
Pain and Suffering	8	0	18.24%	1 6.24%	9.35%
Long Term Medical Care	151	0	30.75%	2 6.92%	1 3.96%
Rec/Corr. Surgery	15	0	33.95%	3 0.11%	1 7.10%
Orthotics and Prosthetics	14	0	31.48%	2 7.94%	1 5.90%
Ambulatory Devices	15	0	33.95%	3 0.11%	1 7.10%
Plaintiff Lost Earnings	301	0	91.65%	8 2.08%	5 0.36%
<b><u>Original 50A Elements</u></b>					
Pain and Suffering	8	0	18.24%	1 6.24%	9.35%
Long Term Medical Care	151	0	38.91%	3 4.26%	1 8.71%
Rec/Corr. Surgery	15	0	38.06%	3 3.67%	1 8.98%
Orthotics and Prosthetics	14	0	34.98%	3 0.98%	1 7.51%
Ambulatory Devices	15	0	38.06%	3 3.67%	1 8.98%
Plaintiff Lost Earnings	301	0	121.90%	108.15%	6 4.20%
<b><u>New York 50B</u></b>					
Pain and Suffering	10	0	23.52%	2 0.90%	1 1.96%
Long Term Medical Care	151	0	34.77%	3 0.25%	1 5.15%
Rec/Corr. Surgery	15	0	38.06%	3 3.67%	1 8.98%
Orthotics and Prosthetics	14	0	34.98%	3 0.98%	1 7.51%
Ambulatory Devices	15	0	38.06%	3 3.67%	1 8.98%
Plaintiff Lost Earnings	301	0	121.62%	107.89%	6 4.03%
Household Support	151	0	40.72%	3 6.00%	2 0.23%
Loss of Consortium	151	0	40.72%	3 6.00%	2 0.23%