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In This Issue

In this issue of The Expert Witness, we present two articles concerning the component of the plaintiff's award that is referred to as the "management fee." What we argue is that there are actually two types of such fees.

The first of these, and the one that is usually discussed under the generic term "management fee," refers to expenses that plaintiffs incur for advice concerning ***investment*** decisions. The first article in this newsletter discusses the arguments, both for and against, inclusion of the cost of this *investment management fee* in the plaintiff's award. After a detailed analysis of this issue, we conclude that such a fee is justified only in exceptional circumstances.

A second form of management fee may arise in cases in which plaintiffs have suffered impairment in their mental capacity – usually children injured at birth or adults injured in catastrophic accidents. As these individuals often require assistance with many, if not most, of the decisions concerning management of the ***expenditure*** of their awards, a second fee, an *expenditure management fee*, may be necessary.

The second article in this issue identifies three potential components of this fee: the costs of guardians, life care planners, and trustees. It concludes that, although this fee may well be substantial - perhaps on the order of $50,000 per year – it is often given very little attention by cost of care and financial experts.

Economica News

Derek Aldridge and Christopher Bruce's article, "Estimating the Impact of Mid-Career Retraining," has been accepted for publication by the *Journal of Legal Economics*. This article asks whether a plaintiff who has retrained in a new occupation will start at an entry-level income in that occupation, or at the income of an individual with the plaintiff's calendar age. For example, if a 40 year-old plaintiff retrains as a drafting technologist, will he or she earn the income of, say, a 25 year-old technologist, or that of a 40 year-old?

The Cost of Managing the Plaintiff's Investments

Christopher J. Bruce

As most individuals are unaccustomed to managing large sums of money, it may be appropriate for plaintiffs to employ advisors to assist them with the investment of their awards. In these cases, it has often been argued that the cost of hiring such advisors should be added to the value of the award. This cost is referred to as a *management fee or financial management fee*.

The fees that are charged by financial advisors are almost universally quoted as a percentage of the total value of the amount that has been invested. For example, the fee charged by a bank or trust company for managing an investment of $1 million might be 2.0 percent of that investment, or $20,000 per year. This percentage normally declines as the size of the investment increases. For example, on an investment of $3 million, it might be 2.0 percent on the first $2 million and then 1.5 percent on the next $1 million.

The effect of the management fee is to reduce the net value of the rate of interest, or discount rate, obtainable by the plaintiff. For example, assume that a trust company is able to obtain a rate of return of 5.0 percent (after accounting for inflation) on an investment of $1 million, and that the management fee is 2.0 percent. The income earned in each year will be 5.0 percent of $1 million, or $50,000. But from that will be deducted a 2.0 percent management fee, or $20,000. Thus, the net return on the investment will be $30,000 ($50,000 – $20,000), which represents a 3.0 percent net rate of return on the investment.

When calculating the value of the plaintiff's award, the financial management fee could be taken into account either by adding the dollar cost of the financial advisor to each year's losses, or by discounting the future losses by the net rate of return on investments. The former approach requires the calculation of the management fee for each year in the future, whereas the latter requires only that the rate of return on investments be replaced by the *net* rate of return (3.0 percent is used in the example above instead of 5.0 percent). Thus, as both approaches produce the same estimate of the award, economists generally prefer to use the simpler approach: the net rate of return.

Assume that it has been agreed that plaintiffs should place their awards in a particular type of investment portfolio, and that the projected rate of return on that portfolio is, say, 4.5 percent. If the financial management fee is 1.75 percent, the appropriate discount rate would be 4.5 percent minus 1.75 percent, or 2.75 percent.

This is the basis of the argument that is often made in court: that a (financial) management fee must be deducted from the discount rate to obtain a "true" net discount rate.

Although this argument sounds reasonable, it is not – for the simple reason that in most cases in which financial experts testify concerning the value of "the discount rate", it is a *net* discount rate to which they are referring. That is, they are referring to a rate from which the management fee has already been deducted. Thus, it is not necessary to deduct a further management fee from the recommended discount rate – the latter already includes a management fee.

What I wish to show in the following two sections is that whether it is necessary to deduct the management fee will depend upon the way the discount rate has been determined.

In the first of these sections, I will consider four situations in which the court has used testimony from expert witnesses to select the discount rate. In the second section, I will consider those cases in which the discount rate has been mandated by government regulation.

Court Selected Discount Rate

The courts have been clear that plaintiffs are expected to invest their awards in financial assets that do not expose them to unreasonable risk. For example, in its seminal decision in *Lewis v. Todd* (1980 CarswellOnt 617), the Supreme Court of Canada approved of the expert's use of "high grade investments [of] long duration." [para. 17] Financial experts have generally held that this implies that the plaintiff's award should be invested in a balanced portfolio of conservative financial assets – for example in a mix of government bonds, high-grade corporate bonds, and "blue chip" stocks.

In this section, I will consider four approaches that plaintiffs could take to the investment of their awards; and investigate whether it would be appropriate to deduct a management fee in each of them. These approaches assume that the plaintiff will either:

- Purchase mutual funds that spread their investments across balanced portfolios of financial assets.
- Employ a financial advisor to assist them with decisions concerning their investments.
- Use their own expertise to invest in financial markets.
- Purchase a structured settlement.

Under the first three of these approaches, I assume that the plaintiff, and his or her advisors, will attempt to balance two goals: maximize the rate of return on investments, and minimize the risks associated with the purchase of financial assets. This balance is achieved by investing in a balanced portfolio of assets spread across a range of potential instruments. (Under the fourth, structured settlement approach, the plaintiff leaves the choice of investments to the provider of the structured settlement.)

Balanced portfolio funds: One method of achieving a balanced portfolio is to purchase a type of mutual fund called a *balanced portfolio fund*. Each of these funds – which are offered by all of Canada's banks, by many investment houses, and by insurance companies – invests in a balanced blend of asset classes. These funds offer numerous advantages to the plaintiff. They reduce risk by spreading their investments across different types of assets, in different industries, and different countries. They offer clearly identified choices concerning the degree of risk that the plaintiff is willing to accept, often ranging from "very conservative" to "aggressive growth-oriented", and the selection of the assets to be incorporated in each fund is made by experts who are supported by teams of researchers.

Furthermore, balanced portfolio funds offer the attractive feature that the rates of return that they have earned are publicly available. Thus, not only can the plaintiff-investor determine easily what any fund's performance has been; but the rates of return on those funds can be used by the courts as objective measures of the returns that are available to plaintiffs when they invest in conservative, balanced portfolios.

The interest rates that are reported publicly, on balanced portfolio funds, are *net* of management fees. For example, if a fund earns 4.5 percent on its investments, and the fund's operators charge a fee of 2.0 percent, the published rate will be 2.5 percent. It is information concerning these published rates – that is, rates that are *net* of the fund operators' rates – that Economica uses when discounting plaintiffs' future losses. [See *Selecting the Discount* Rate, Expert Witness, Vol. 21, Spring 2017.] As these rates are net of the operators' fees, there is no need to add a "management fee."

Financial advisor: Instead of purchasing a mutual fund "off the shelf," the plaintiff could employ a financial advisor to purchase a balanced portfolio of investments, specific to the preferences of the plaintiff. Generally, these advisors charge a fee that equals approximately 1.0 to 2.0 percent of the value of the assets that they are managing. Is there an argument for adding the cost of this advice to the plaintiff's award, as a management fee? I will argue that the answer is "no."

To see why, consider the following example: assume that a financial advisor who charges a management fee of 2.0 percent is able to obtain a rate of return of 5.0 percent. The *net* rate of return received by the advisor's clients will be 3.0 percent. [For example, $100,000 invested at 5.0 percent will generate a return of $5,000 per year and, with a management fee of 2.0 percent, will cost $2,000 per year. Thus, there is a net gain of $3,000, which is 3.0 percent of the invested amount.]

In this case, the appropriate discount rate will be the net rate of interest obtained by the advisor, or 3.0 percent. For example, to determine how much would have to be invested today to replace a $103,000 loss a year from now, one would divide $103,000 by 1.03 (= 1 + the interest rate), to get $100,000. When future losses are discounted by this rate, the costs of the advisor's services have been accounted for in the calculation – the $3,000 gain after one year equals the return on the investment, $5,000, minus the advisor's fee, $2,000.

Thus, if the discount rate that is used by the court to calculate the value of the plaintiff's award equals the *net* investment return obtainable by the financial advisor, no additional allowance needs to be made for a management fee.

Although the rates of return obtainable by financial advisors are not publicly available, a reliable objective measure of that rate is the rate of return on balanced portfolio funds. As independent financial advisors generally rely on the same research that is available to the operators of mutual funds (they usually work for the same financial institutions), they can be expected invest in portfolios of financial assets that are similar to those that are contained in balanced portfolio funds. They can, therefore, be expected to generate similar rates of return *net of management fees*.

If that is true, then the estimate of the return available to independent advisors includes an allowance for the management fee, and no additional management fee need be awarded.

Self investment: In those cases in which plaintiffs are expected to use their own skills to invest their awards, there will be no (or only minor) management fees and, hence, no call for such fees.

Structured settlement: The cost of any structured settlement includes the cost to the issuer of managing that settlement. Hence, again, there would be no need for an additional management fee.

Summary: I can find no situation in which it would be necessary to award a management fee to a plaintiff who is mentally competent.

Mandated Discount Rate

An argument might be made for the award of management fees in those cases in which the discount rate mandated by the government exceeds the rate predicted by the experts before the court.

Assume, for example, that the mandated rate was 3.0 percent and that the best evidence before the court was that the *net* rate of return available on a balanced portfolio of funds was 2.0 percent. It could be argued that the difference between the two rates had arisen because the mandated rate reflected the rate of return available *before* deduction of management fees. In that case, it might be appropriate to award a management fee of 1.0 percent, to bring the net discount rate to 2.0 percent.

It must be pointed out, however, that the rates currently mandated in British Columbia, Ontario, and Saskatchewan are significantly lower than the net rates available on balanced portfolio funds. Hence, although there is a case for awarding management fees *in some cases*, the conditions for those cases do not exist at this time.

Conclusion

In virtually every situation in which financial experts testify concerning the value of the discount rate, the rate of return that they refer to is *net* of the cost of investment. Hence, it is not necessary to deduct a financial management fee. And, although such a deduction *might* be necessary in cases in which a mandated discount rate had been used, the rates that have been mandated in Canada in recent years are so low that it must be concluded that they are also net of management fees.

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The Cost of Managing the Expenditures of a Plaintiff with Reduced Mental Capacity

Christopher J. Bruce

When referring to plaintiffs with normal mental capacity, the term "management fee" usually refers to expenses that plaintiffs incur for advice concerning ***investment*** decisions. Decisions concerning how their awards are to be spent – on medical care, accommodation, transportation, etc. – can generally be left to the plaintiffs themselves.

Plaintiffs who have suffered an impairment in their mental capacity – usually children injured at birth or adults injured in catastrophic accidents – however, may require assistance with many, if not most, of the decisions concerning ***expenditure*** of their awards. In this article, I propose to include the cost of this assistance in the term "management fee" and to investigate what the determinants of this fee will be in the case of plaintiffs with reduced mental capacity.

In the first section of this article, I enumerate the various types of assistance that will be required by these plaintiffs. I call this the "hierarchy of needs," as the responsibility for this assistance involves a pyramid, or hierarchy, of decision-makers. In the second section, I investigate the costs of this assistance.

A Hierarchy of Needs

The management of the plaintiff's award requires four types of agents:

Financial manager: Once the court award has been paid to the plaintiff, that amount will have to be invested. This will require either that a trust company invest the award in a portfolio of conservative financial assets, or that a structured settlement be purchased from an insurance company. In either case, a fee may be charged for the management of the plaintiff's finances. (These are the fees that were discussed in the first article in this edition of the *Expert Witness*, "The Cost of Managing the Plaintiff's Investments.")

Guardian – The role of the guardian is to determine how the invested funds are to be spent: to ensure that the plaintiff is provided food, clothing, shelter, transportation, health care, and emotional care. Generally, it is not intended that the guardian will provide these services directly but will, instead, be responsible for hiring an agent called a case manager (see below), and for providing that individual with directions concerning the types and levels of services that are required. The guardian, for example, might decide that the plaintiff should be moved from his or her own home to a nursing home, but leave the decision about the selection of a specific nursing home to the case manager.

Often, the guardianship function will be performed by a committee which might, for example, include family members, legal representatives, social workers, and a *life care planner/cost of care expert*. The latter are experts who assist the guardian with the development and implementation of a plan for the care of the plaintiff.

Rehabilitation case manager - The guardian will often consider it necessary to contract with an agent to implement the plan that was developed in coordination with the life care planner. This individual is usually called a *rehabilitation case manager*, or simply *case manager*. He or she takes direction from the guardian and reports to the trustee (see below).

These individuals are responsible for:

- the physical safety and emotional and social well-being of the individual in the community – for example, contracting with rehabilitation specialists, physical therapists, educational consultants, and speech and language consultants;
- contracting with care personnel, such as rehabilitation assistants, home support workers, and nursing staff as warranted by the nature and extent of the injuries sustained and the impact of the impairments on functional ability; and
- purchasing and maintaining goods and services, including medically-required equipment, such as wheelchairs and modifications to automobiles.
- They are also responsible for monitoring all of the service-providers that have been hired, to ensure that their functions are being carried out as specified, and for replacing any employees who have resigned or been laid-off.

[As the case manager's role is primarily to *arrange* for the purchase of goods and services, he or she may hire a subsidiary set of agents who make the actual purchases. Hence, there may be an additional layer of agents in the hierarchy: *purchasing agents*.]

Trustee: The trustee performs a "gatekeeping" role, ensuring that the bills incurred on behalf of the plaintiff are paid, that relevant income taxes are remitted, and that expenditures are not mismanaged (or misappropriated). Although one person (for example, a close relative) could act as both guardian and trustee, it is generally recommended that these two functions be separated, in order to provide independent checks on spending patterns.

Management fees

Payment may have to be made to each of the four categories of agents described above. I consider each of them separately here.

<u>Financial Manager</u>: As brain injured plaintiffs and children cannot make their own financial decisions, a third party will have to be employed to *invest* plaintiffs' awards. Two options

are available: a *trust company* may act as an investment manager, or an *insurance company* may provide a structured settlement.

If a trust company has been employed, it will provide its services for a fee that normally varies from about 1.0 percent to 2.0 percent of the value of the investment. Thus, for example, if the trust company is able to obtain a rate of return of 4.0 percent on the investment, from which it deducts a fee of 1.0 percent, the *net* rate of return will be 3.0 percent. Technically, the financial manager's fee could be included as one of the costs of caring for the plaintiff. However, the data we recommend the courts use when calculating discount rates - the return on balanced portfolio funds (discussed in the first article in this edition of the *Expert Witness*,) – and the discount rates that are mandated by many provinces, are already *net* of investment companies' management fees. Thus, in practice, no additional allowance will be required.

Similarly, insurance companies' prices for structured settlements incorporate their costs of management. Hence, if the plaintiff's award has been paid as a structured settlement, it may not be necessary to provide a separate allowance for the insurer's management fee.

[Note, however, that although it is generally not necessary to include a fee for the financial manager, it may be necessary to include a fee for the *trustee* (see below).]

<u>Guardian/life care planner</u>: There are three potential sources of guardians: the *relatives* of the plaintiff, a *public agency* (often referred to as the Public Trustee's Office), or a *private agent*.

Relatives: When brain damage arises from negligence at birth, the parents of the injured child will often act as guardians; and when injury occurs later in life, guardians may be selected from spouses, parents, siblings, adult children, or other relatives. To the extent that these individuals are willing to work for free, it might be argued that no claim for their services can be made against the defendant. However, two counterarguments can be made.

First, for the same reason that relatives are often able to claim for the costs of providing household services or nursing care to the plaintiff, they may also be able to claim compensation for the time and effort required to act as guardians. Second, some allowance must be made for the possibility that the relative-guardian will die before the plaintiff and, therefore, that a third party will be needed.

When either of these arguments is accepted, the cost of guardianship can be calculated as the cost that would have been charged by a public or private guardian. (For these, see below.)

Public Agency: Depending on the jurisdiction, Public Guardians may not charge fees for their services, or may charge a below-market fee. It should be noted, however, that all of the experts we have consulted have recommended that, if plaintiffs have large awards, they should not rely on the office of the Public Guardian, as the latter generally deals with relatively small sums.

Private Guardian or life care planner: If it is felt that the Public Guardian is not appropriate, it may be necessary to hire a private guardian. A number of knowledgeable individuals have suggested to me that a *life care planner* might fill this role. As the function of this individual is to develop a plan for the care of the plaintiff and to ensure that that plan is implemented as intended, it may require only a limited number of hours – perhaps five to ten per month – at approximately $200 per hour. Thus, an annual allowance of approximately $20,000 would not be unreasonable.

A guardian committee may also include a lawyer. If we assume five hours per month at $300 per hour, the annual fee would be $18,000.

<u>Rehabilitation case manager</u>: The costs of hiring rehabilitation case managers vary significantly depending on the severity of the injury to the plaintiff. A U.S.-based life care consulting firm, Caragonne and Associates, has developed an "assessment protocol" for calculating the number of hours of case management that will be required for seriously injured clients. The protocol identifies five dimensions of care, and scores each dimension on the degree of involvement required from the case manager: from low, through moderate, to high. The five dimensions are:

1) *Level of client's independence*: This dimension measures the extent to which the client needs advice and encouragement. It ranges from high independence, in which the client requires only "periodic encouragement" from the case manager, to low independence/high need, in which frequent intervention is required to assist and orient the client.
2) *Number of providers of needed services*: This dimension ranges from low intervention, in which the client has obtained the resources needed, to high intervention, in which the case manager will have to contact multiple agencies and providers to arrange for the goods and services needed by the client.
3) *Frequency of appraisal*: The more often can the client's status be expected to change, the greater will be the need for reappraisals by the case manager.
4) *Coordination of providers*: Once a life care plan has been put into place, the case manager will have to coordinate the implementation of that plan. The greater is the number of providers that have to be coordinated, and the more frequent is the number of interventions, the greater will be the number of hours worked by the case manager.
5) *Travel*: The further the case manager has to travel in order to meet with the client and his or her providers, the greater will be the number of hours required.

Caragonne and Associates estimate that if the client's needs are rated as "high" on four or more of these dimensions, case management will require eight to twelve hours per month. If the client's needs are rated as "moderate" on most of the dimensions, case management will require five to seven hours per month. Even a "low" rating on most dimensions will require one to four hours per month.

As many brain-injured clients and child plaintiffs will require a high level of services on most of the Caragonne dimensions, it can be expected that case management will require eight to twelve hours per month. Assuming ten hours per month, at $100 per hour, a case manager would cost approximately $12,000 per year.

<u>Trustee</u>: When trust companies act both as financial managers of the plaintiff's award and as trustees of the plaintiff's expenditures, they may offer a rate that is lower than the sum of the financial management fee and the trustee's fee. As practices will vary among companies, it is important that counsel receive clear quotations for the sum of the two services.

If the Public Trustee acts as trustee, it may charge for its services. In Alberta, for example, that fee equals three-eighths of a percent of the total size of the investment – that is, $3,750 per year for each $1million.

When a structured settlement has been purchased from an insurance company, the insurer will not act as trustee. Hence, an additional fee for that service will often have to be calculated. RBC, for example, will act as trustee of a structured settlement for a charge of 5% of the annual annuity payment, subject to a minimum annual fee of $7,500. Tax preparation services would be in addition, at hourly rates, likely under $1,000/yr.

Summary

It has been our observation at Economica that when the courts use the term "management fee" they are usually referring to the fee for a financial manager, to supervise the *investment* of the plaintiff's award. What I have argued in this article is that, when the plaintiff is a child or has been brain injured, there are at least three other classes of agents who will be responsible for managing the *expenditure* of the award, and who may also have to be compensated. In those cases, therefore, the "management fee" may extend well beyond the value normally considered by the courts.

Most importantly, allowance may have to be made for compensation of the guardian, the life care planner, and the case manager; and, when the award has been invested in a structured settlement, allowance may have to be made for trustee fees. As these fees could well exceed $50,000 per year, they could add over $1million to the size of the award to a young person. Hence, it is crucial that these sources of cost be considered seriously.

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