

THE NEW METHOD OF STRUCTURING SETTLEMENT AGREEMENTS

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The new method of structuring settlement agreements makes structured settlements available to all insurers who were previously unable to structure. The Advance Income Tax Ruling issued by Revenue Canada concerning the new method is unique in that it deals with the tax effect of a structure for the defendant and its casualty insurer and not merely its tax effect for the plaintiff. The previous impediments to the use of structures for self-insurers, foreign insurers and reinsurers and the administration cost of structured settlement agreements for all insurers are avoided.

The new method of structuring settlements requires the defendant or its casualty insurer to conditionally assign the performance of the structure. To avoid any adverse tax consequences and to meet all other regulatory requirements, the assignee must meet certain financial conditions; be an insurance corporation; and, the conditional assignment agreement must be in the form of an insurance contract.

La nouvelle méthode mise en place pour le règlement échelonné des dommages-intérêts a pour résultat de mettre ce genre de règlement à la disposition de tous les assureurs qui jusque-là ne pouvaient en tirer parti. La décision anticipée en matière d'impôts qui a été publiée par Revenu Canada sur cette nouvelle méthode est remarquable en ce qu'elle traite des effets fiscaux de l'échelonnement non seulement du point de vue du demandeur mais aussi du point de vue du défendeur et de son assureur de risques divers. Le coût administratif de ces règlements est dorénavant épargné à tous les assureurs et les obstacles qui empêchaient jusque-là les non-assurés, assureurs étrangers et réassureurs de tirer parti de ces règlements échelonnés ont disparu.

Cette nouvelle méthode de règlements échelonnés force le défendeur ou son assureur de risques divers à céder conditionnellement à un tiers l'exécution de ce genre de règlement. Pour éviter de lourdes conséquences fiscales ainsi que pour remplir toutes les conditions réglementaires, le cessionnaire doit d'une part remplir certaines conditions financières, et d'autre part être une société d'assurance; enfin l'accord de cessation conditionnelle doit être conçu sous forme de contrat d'assurance.

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The author wishes to acknowledge that the successful implementation of the new method of structuring settlement agreements was the result of the collaborative effort of John Bowles and Jim Madge of the Toronto Legal Services Department of Canadian Pacific Limited; John Lynch, Assistant Director of Taxation of Canadian Pacific Limited; Gary McLeod and Bernard Younder of TSSC Structured Settlements Ltd.; John Bassel, Murray Davison and Bill Irwin of Bassel, Sullivan, Leake & Davison; Chico Korbee of the former Bassel, Sullivan & Leake; and Mark Wallace, formerly of Bassel, Sullivan & Leake and now with Unitel Communications Inc. Thanks go to John Porter, now with Meighen, Demers, Peter Rizakos of the former Bassel, Sullivan & Leake, and Laura Embree of Bassel, Sullivan, Leake & Davison for their helpful comments.

Introduction

Canadian Pacific Limited, a self-insurer,¹ with the assistance of TSSC Structured Settlements Ltd., has been successful in implementing in Ontario a new method of structuring settlement agreements pursuant to an Advance Income Tax Ruling² (the "Ruling") issued by Revenue Canada. The approval of the new method of structuring settlement agreements implicit in the Ruling will have far reaching effects on the structuring of settlement agreements and, where appropriate, of judgments. The Ruling is significant as it allows an additional method by which all settlement agreements or judgments may be structured, thereby making them available to plaintiffs, defendants and types of insurers³ who, until now, could not structure settlement agreements due to the perceived and actual consequences of them which presently arise under the Income Tax Act.⁴

The comparative advantages and disadvantages of periodic awards of damages and, by inference, structured settlement agreements and judgments, have been the subject matter of much comment and, recently, consideration by the Supreme Court of Canada.⁵ Whatever the disadvantages, it is sufficient to state that the advantages of structuring periodic awards of damages in a judgment or by agreement of the parties are of such importance that structuring is increasingly receiving more widespread world-wide legislative and governmental recognition.⁶ The fundamental purpose of securing the Ruling was to ensure that self-insurers, such as Canadian Pacific Limited, and, by extension, all plaintiffs with causes of action for damages for personal injury, whatever the identity of the defendant or its casualty insurer, if any, have the advantages of structures available to them.

A preliminary difficulty that was encountered in seeking to implement the new method of structuring settlement agreements was the multiplicity of jurisdictions in Canada that have control over various aspects of the

¹ As used in this article, the term "self-insurer" denotes any commercial or professional entity which provides its own casualty risk coverage through either a large deductible under its insurance coverage or by a large pool of funds accumulated for that purpose, including business entities such as Canadian Pacific Limited, hospitals, many professional organizations and entities which participate in pooling arrangements.

² Advance Income Tax Ruling No. 3-2425.

³ The term "insurers" as used in this article includes all types of insuring entities such as insurance corporations registered federally or provincially to transact the business of insurance, self-insurers, unregistered foreign insurers and reinsurers.

⁴ Income Tax Act, S.C. 1970-71-72, c. 63, as amended.

⁵ *Watkins v. Olafson, Aitkenhead and Government of Manitoba*, [1989] 2 S.C.R. 750, at pp. 756-758, (1989), 61 D.L.R. (4th) 577, at pp. 580-581, [1989] 6 W.W.R. 481, at pp. 486-487.

⁶ *Ibid.*, at pp. 757-758 (S.C.R.), 480 (D.L.R.), 487 (W.W.R.).

structuring of settlement agreements. Structured settlement agreements come within the federal jurisdiction (to the extent they are insurance related and are tax driven agreements), the provincial jurisdictions (to the extent they are insurance related and are matters of contract and involve the administration of justice), the jurisdiction of the courts (to the extent they involve actions which are before them), and the jurisdiction of Official Guardians or similar officials with authority in relation to infants and other plaintiffs without legal capacity. The form of a particular settlement agreement also reflects the bargain of the parties to it in the context of the constraints which must be observed in order to obtain the tax benefits resulting from Interpretation Bulletin IT-365R2⁷ of Revenue Canada (The "Bulletin").

Despite the number of jurisdictions having authority over various aspects of a structured settlement agreement or judgment, there has been a minimal exercise of that authority to facilitate their use. This near void of authoritative edict has been an almost complete impediment to the use of structured judgments and has inhibited the use of structured settlement agreements.

The process of developing a new method of structuring settlement agreements and having it authoritatively approved was therefore not only complicated by the multiple jurisdictional and contractual issues involved in the context of a structured settlement agreement, but, as well, by the lack of a defined forum in which to resolve those issues in a co-ordinated and comprehensive manner. The cause of action in respect of which the Ruling was obtained occurred in Ontario. This permitted the narrowing of the jurisdictional boundaries which were required to be observed. Within those boundaries, however, there was little concrete direction as to any required criteria for a structured settlement agreement. To-date the Bulletin has provided the most complete exercise of jurisdiction in relation to structures. Both for that reason and as structures are primarily tax effect oriented, the sanction of Revenue Canada was of primary importance to the process of developing the new method of effecting structures.

Until the amendments⁸ of section 129 of the Courts of Justice Act, 1984,⁹ to provide for the structuring of judgments, there was no legislation in Ontario permitting structures of judgments or affecting structures of settlement agreements. This legislation, however, merely permits the periodic payment of an award for damages on the consent of all parties and does not address the subject matter of the required content of a structured settlement agreement or judgment. The only other criteria which have been

⁷ Interpretation Bulletin No. IT-365R2, May 8, 1987, para. 5.

⁸ S.O. 1989, c. 67, s. 3.

⁹ Courts of Justice Act, 1984, S.O. 1984, c. 11, as amended.

suggested to be in existence in Ontario in relation to structures were the supposed requirements that the issuer of the annuity contract (the "Issuer") that is acquired to fund the periodic payments under the settlement agreement be both federally licensed and have \$3,000,000,000.00 in assets.¹⁰

It was also recognized that, as the subject of the settlement agreement was an insurance claim and part of the solution being sought involved other insurance matters, the review of the appropriate insurance regulators under their general administrative jurisdiction was required. Lastly, the circumstances of the case in respect of which the Ruling was obtained brought the new method of structuring settlement agreements to the attention of the Official Guardian and made it necessary to secure his sanction. Accordingly, the process of developing the new method of structuring settlements involved not only the participation and consent of the parties to the action and the Issuer but, as well, the favourable opinion of Revenue Canada, the Ontario Courts (General Division), the Office of the Superintendent of Financial Institutions of Canada, the Ontario Insurance Commission and the Official Guardian of Ontario.

The tactical approach adopted in establishing the new method of structuring settlement agreements was first to secure the consent of Revenue Canada. Without the beneficial tax effect, there is no purpose to structuring a settlement agreement. Revenue Canada must be complimented for their clear perception of the benefits of the new method of structuring settlement agreements and their patience and co-operation in permitting it to be established.

I. The Current Method

A. The Requirements of the Bulletin and the Structure of a Structure

A clear understanding of the very technical aspects of the requirements of the Bulletin is necessary in order to understand both the adverse consequences of the current method of structuring settlement agreements and the benefits achieved by the new method recognized by the Ruling. A prerequisite to achieving that clear understanding is comprehending the contractual nature of the relationship of the parties to a structured settlement agreement and the focus of the Bulletin in addressing these relationships.

A structured settlement agreement is a three party relationship and is best viewed, schematically, as triangular in nature. The first relationship or the base of the triangle is the one established by a cause of action for damages for personal injury settled by minutes of settlement entered into among the plaintiff, the defendant and the defendant's casualty insurer, if any, providing for a structure to be put in place. The second relationship is established among the defendant, its casualty insurer, if any, and the

¹⁰ No authority for these criteria was revealed by our research.

Issuer through the structuring of the settlement agreement by the acquisition of the annuity contract to fund the structured settlement payments. This is the second arm of the triangle to come into existence. The third relationship is between the Issuer and the plaintiff by reason of the receipt of the payments by the plaintiff pursuant to the structured settlement which are funded by the annuity contract. This is the final arm of the triangle to come into existence.

Although these three relationships are interrelated, the Bulletin prescribes exact conditions for each of them, including restrictions on the extent of the contractual privity and the flow of the benefits of the contractual relationships among the various parties, which preserves them as three separate and distinct relationships. The settlement agreement, which provides for a structure to be put in place, establishes the initial relationship with contractual privity only between the plaintiff and the defendant or its casualty insurer, if any, and provides for a stream of periodic payments to be made to the plaintiff. Under the current method of structuring settlement agreements, the structure is implemented by the defendant's casualty insurer acquiring an asset from the Issuer in the form of an annuity contract designed to fund the liability to make the periodic payments under the settlement agreement. This acquisition "structures" the settlement agreement and establishes the second distinct contractual relationship with privity only between the defendant's casualty insurer and the Issuer. Pursuant to the second contractual relationship an irrevocable direction is delivered by the defendant's casualty insurer to the Issuer to make the payments under the annuity contract to the plaintiff. This direction and the making of the payments pursuant to it is the third relationship. However, there can be no contractual privity between the Issuer and the plaintiff for the desired tax effect to be achieved for the plaintiff. At best this third relationship is, as a matter of contract law, a third party relationship to the contractual relationship between the defendant's casualty insurer and the Issuer. These distinct contractual relationships and the restrictions on them must continue to be observed in both the current method of structuring settlement agreements and the new additional method of structuring settlement agreements.

While the Bulletin defines the skeleton of the second relationship (that is, the purchase of an annuity contract; the making of the irrevocable direction; and, the obligation of the defendant or its casualty insurer to remain liable to the plaintiffs), its focus is the tax effect for the plaintiff of the first and third relationships. The Bulletin clearly defines the conditions which must be met for the plaintiff to receive the periodic payments under the annuity contract on a tax free basis. This focus of the Bulletin has either been overlooked or misunderstood. As a result many misconceptions have developed as to the applicability of the Bulletin to the second arm of the triangle, being the relationship among the defendant, its casualty insurer, if any, and the Issuer. Previous attempts to develop alternatives

to the current method of structuring settlement agreements have been based on substituting entities which are not insurance corporations¹¹ for the defendant's casualty insurer's role in a structured settlement agreement. That tax effect is pivotal to securing the desired tax benefit for the plaintiff in structuring a settlement agreement pursuant to the Bulletin.

Aside from providing the mere skeleton of the relationships among the defendant, its casualty insurer, if any, and the Issuer for the purpose of establishing the conditions that must be met in order to accomplish the desired tax benefit for the plaintiff, the Bulletin is silent as to either the conditions to be met in relation to or the tax effect for the defendant and its casualty insurer, if any, of a structured settlement agreement. The tax effect for the defendant and its casualty insurer, if any, of a structured settlement agreement is presently determined under the general provisions of the Income Tax Act and the regulations made thereunder. It is the tax consequences of the present method of structuring settlement agreements in combination with the misconceptions arising from the language employed in the Bulletin which have been the source of the real or perceived impediments to the effective use of structured settlement agreements by many types of defendants and insurers. The focus of the Ruling is the conditions, which if met, eliminate the adverse tax consequences for a defendant which is not an insurance corporation of using structured settlement agreements. The effect of the Ruling will be to dispel these misconceptions and to eliminate nearly all of the real or perceived impediments to the more widespread use of structured settlement agreements. It also provides to insurers an alternative method of structuring settlement agreements which eliminates some practical adverse consequences which arise for them out of the current method of structuring settlement agreements.

B. *Current Method of Structuring Settlements*

The current method employed in structuring settlement agreements in order to achieve the desired tax effect for the plaintiff under the Bulletin is as follows:

- (1) The plaintiff and the defendant's casualty insurer enter into a settlement agreement in respect of a claim for damages resulting from personal injury or death requiring periodic payments to be made to the plaintiff for a specified term.¹²
- (2) The defendant's casualty insurer acquires an annuity contract from an Issuer to fund the periodic payments to be made under the settlement agreement. The annuity contract must be for a single premium and be non-assignable, non-commutable and non-transferable and relate to the settlement agreement.¹³

¹¹ Income Tax Act, *supra*, footnote 4; "insurance corporation" and "insurer" are defined in ss. 138(1) and 248(1).

¹² Interpretation Bulletin, *supra*, footnote 7, ss. 5(a) and 5(b).

¹³ *Ibid.*, s. 5(c)(i).

- (3) Revenue Canada requires that the defendant's casualty insurer be the beneficiary under the annuity contract. In the view of Revenue Canada, if the plaintiff were to be the annuitant, the plaintiff would have a direct interest in the annuity contract and the payments made under it would be taxable in the hands of the plaintiff. The casualty insurer must therefore be the beneficiary and make an irrevocable direction to the Issuer to make all payments under the annuity contract to the plaintiff.¹⁴
- (4) The defendant's casualty insurer must remain liable to make the payments required under the settlement agreement.¹⁵ From the point of view of Revenue Canada this provision does not go to the aspect of the security of payment to the plaintiff, but to the "wash" effect for tax purposes of structured settlement agreements as will be subsequently discussed.
- (5) For the defendant's casualty insurer the tax treatment afforded the payment of the single premium paid for the issuance of the annuity contract is to be determined under the Income Tax Act¹⁶ and the regulations made thereunder¹⁷ and is not directly addressed in the Bulletin. The casualty insurer is permitted to deduct the present value of its present and future liability under the settlement agreement (that is, the amount of the premium) as a reserve in the year of payment.¹⁸
- (6) The tax treatment for the payments made under the annuity contract for the defendant's casualty insurer is again established under the Income Tax Act and is not directly addressed by the Bulletin. The defendant's casualty insurer must include in the calculation of its income the amount of all payments it receives under the annuity contract in the fiscal year.¹⁹ The defendant's casualty insurer is then entitled to a corresponding deduction in the calculation of its income for the fiscal year of an amount equal to the capital element of each annuity payment²⁰ and, as it is in the insurance business (that is, an enterprise undertaken with a view to earning a profit), a deduction equal to the amount of the income portion of each annuity payment as paid by it to the plaintiff in each fiscal year as an expense incurred in its business.²¹ This effects the "wash" for the defendant's casualty insurer in respect of the payments that are notionally received by it under the annuity contract and applied to settle its liability to the plaintiff under the settlement agreement.
- (7) The receipt of the annuity payment by the plaintiff pursuant to the structured settlement agreement is, in the view of Revenue Canada, non-taxable as a payment for damages.²²
- (8) The only other criteria suggested as being presently required to be satisfied before a court in Ontario will sanction a settlement agreement structured in this manner are that the Issuer must be both federally licensed and have a minimum of \$3,000,000,000.00 in assets.²³

¹⁴ *Ibid.*, s. 5(c)(ii).

¹⁵ *Ibid.*, s. 5(c)(iii).

¹⁶ *Supra*, footnote 4, ss. 20(7)(c) and 138(3)(a)(i).

¹⁷ Income Tax Act Regulations C.R.C. 1978, C. 945, as amended, Part XIV, ss. 1400(e) and 1401(1)(d).

¹⁸ *Supra*, footnotes 16, 17.

¹⁹ Income Tax Act, *supra*, footnote 4, ss. 12.2 and 56(1)(d).

²⁰ *Ibid.*, s. 60(a).

²¹ *Ibid.*, s. 9.

²² Interpretation Bulletin, *supra*, footnote 7, s. 5.

²³ *Supra*, footnote 10.

C. *Adverse Consequences of the Current Method of Structuring Settlements*

Under the current method of structuring settlement agreements the following adverse consequences result, which in some instances are an irritant and, in others, a complete impediment to the use of structured settlement agreements.

1. *For All Insurers*

The requirement that the insurer must be the owner of the annuity contract results in the consequence that the annuity contract must be recorded as an asset and the settlement agreement as a liability on the balance sheet of the casualty insurer. This results in a distortion of the financial statements of the insurer and is an irritant to all casualty insurers.

Payments received under the annuity contract by the casualty insurer must, as an accounting matter, be recorded as income and payments made by the casualty insurer under the settlement agreement must be recorded as expense. This record keeping requirement represents a substantial administrative cost for casualty insurers in the use of structured settlement agreements.

These consequences have resulted in the decision by some casualty insurers to avoid the use of structured settlement agreements.

2. *Self-Insurers*

The use of the phrase "casualty insurer" in the Bulletin has been regarded as limiting the class of parties who can contemplate the possibility of structuring settlement agreements to "insurance corporations".²⁴ This commonly accepted interpretation of the phrase "casualty insurer" has been a deterrent to the use of structured settlement agreements by self-insurers. As a result of the misconception arising from the use of this phrase the focus of the Bulletin in addressing the tax effect of structured settlement agreements for the plaintiff has been overlooked. Initiatives taken in the past to secure the more widespread use of structured settlement agreements were defeated by attempts to substitute other types of entities for insurance corporations without regard for the pivotal tax effect of the role of insurance corporations in a structured settlement agreement.

A cost issue which was perceived as a further complication to the use of structured settlement agreements by self-insurers arises in relation to the ability to deduct a reserve under the Income Tax Act. A "reserve" under the Income Tax Act (as opposed to a reserve under generally accepted accounting principles or under the Ontario Insurance Act²⁵) is the ability to deduct in computing income, at the time it is incurred, the full present

²⁴ See, *supra*, footnote 11.

²⁵ R.S.O. 1980, c. 218, as amended.

value of a future liability. The ability to deduct a reserve in the context of a structured settlement agreement is only available to insurance corporations.²⁶

This limited ability to deduct a reserve in computing income prevents the direct substitution of a self-insurer in the role of an insurance corporation in a structured settlement agreement. Such a direct substitution would cause a prohibitive cost effect for the self-insurer. This liability under the settlement agreement is largely a future liability as payments under it are to be made for some time into the future. As it is not entitled to deduct a reserve in the context of a structured settlement agreement, a self-insurer would have to allocate the premium paid for the annuity contract over the term of the settlement agreement and deduct in each fiscal year only that portion of the premium allocable to the liability for payments actually made under the settlement agreement in each fiscal year. This represents a significant cost to the self-insurer in terms of present dollar values. In addition, the inability to deduct a reserve would require the self-insurer to assess the present value cost factor in relation to each potential settlement agreement in order to determine its economic feasibility. The administrative cost arising from the necessity to examine each settlement agreement for its economic feasibility is itself a practical deterrent to the use of structured settlement agreements by self-insurers. The cumulative effects of this inability of a self-insurer to deduct a reserve are such that, even if a self-insurer comes within the meaning of the phrase casualty insurer as used in the Bulletin, the direct substitution of the self-insurer in the role of an insurance corporation in a structured settlement agreement would be avoided by self-insurers on solely economic grounds.

Another critical cost issue which arises in relation to the direct substitution of a self-insurer in the role of an insurance corporation in a structured settlement agreement pertains to the "wash" concept of the present method of structuring settlement agreements. An insurance corporation is entitled to deduct the payments notionally made by it to the plaintiff (that is, through the means of the irrevocable direction and the payment of the proceeds of the annuity contract by the Issuer to the plaintiff) because they are an expense connected with and incurred by it in the business of insurance that is carried on by it with a view to earning a profit.²⁷ A self-insurer is, generally, not engaged in the business of insurance with a view to earning a profit. The eligibility of a self-insurer to deduct these payments and the availability of the "wash" effect under the present method of structuring settlement agreements is dependent on the ability of the self-insurer to expense the payments as being justifiably connected with and incurred by it in its own business for the purpose of earning

²⁶ *Supra*, footnotes 16 and 17.

²⁷ Income Tax Act, *supra*, footnote 4, s. 9(1).

a profit. The eligibility for a self-insurer to take this deduction is a matter of some doubt.

Finally, some self-insurers do not carry on any type of income producing business that makes them eligible to deduct any expenses. These types of self-insurers are therefore totally disqualified from utilizing the “wash” effect on the present method of structuring settlement agreements.

The cumulative effect of the technicalities of the present method of structuring agreements creates, at the minimum, a substantial fiscal impediment and, at the worst, a practical prohibition on the ability of self-insurers to perform directly the role of an insurance corporation in a structured settlement agreement.

3. *Foreign Insurers*

The ability of foreign insurers to structure settlement agreements in Canada is a crucial issue in light of the increasing globalization of the financial market place and the operation in Canada of international businesses who place their insurance coverage elsewhere than in Canada. In many instances the situation has occurred in which, for one reason or another, the only entity available to structure a settlement agreement in relation to an action in Canada commenced by a Canadian plaintiff was either a non-resident foreign insurer or reinsurer. As for self-insurers, the use of the phrase “casualty insurer” in the Bulletin creates uncertainty as to whether foreign insurers or reinsurers can use structures of settlement agreements. For foreign insurers and reinsurers the problem has been the perception that the withholding tax provisions of the Income Tax Act form an insurmountable fiscal impediment to the use of structured settlement agreements by these entities.

Under the current method of structuring settlement agreements the payments made under the annuity contract are legally received by the casualty insurer beneficiary of the annuity contract, although actually paid to the plaintiff pursuant to the irrevocable direction. Under the Income Tax Act a payment made under an annuity contract by a resident to a non-resident is subject to a withholding tax of 25% (unless reduced or exempted by treaty).²⁸ The amount of the withholding tax must be withheld by the Issuer from each annuity payment that, as a legal matter, is payable to the non-resident foreign insurer or reinsurer and is required to be remitted by the Issuer at the time of payment by it.²⁹

The resulting perception has been that these withholding tax provisions of the Income Tax Act impose on a non-resident foreign insurer or reinsurer performing the role of a resident insurance corporation in a structured

²⁸ *Ibid.*, s. 212(1)(0).

²⁹ *Ibid.*, s. 215(1).

settlement not only the cost of paying the premium for the issuance of the annuity contract but, thereafter, the responsibility of funding the 25% (unless exempted or reduced by treaty) shortfall that would occur in respect of each payment made under the annuity contract. As a result, the use of structures of settlement agreements in Canada by non-resident foreign insurers and reinsurers has been impeded due to the perceived adverse fiscal consequences of the current method of structuring settlement agreements.

4. Insolvency of Insurers

The provision of the Bulletin which requires that the annuity contract acquired to fund the settlement agreement be non-assignable, non-commutable and non-transferable has led to the misconception that no assignment of the annuity contract can be made in any circumstances. This creates obvious difficulties if the insurer, which is required to be both the owner and the beneficiary of the annuity contract, becomes insolvent. Even if an assignment of a settlement agreement structured under the current method could be made in the circumstances of an insolvency, the record keeping and administrative costs associated with a structured settlement agreement would be a deterrent to a voluntary assumption of these obligations of an insolvent insurance corporation by other insurance corporations.

There have been some recent notable examples of insolvencies of risk insurance corporations in respect of which these factors resulted in both the practical inability to effect structures in relation to their current claims and the problem of how to deal with their outstanding structured settlement agreements.

5. Conclusion

The cumulative effect of the adverse consequences of the present method of structuring settlement agreements for any entity other than an insurance corporation is to afford to some defendants, insurers and plaintiffs disparate treatment in relation to the availability of structured settlement agreements. In effect plaintiffs who suffer the additional misfortune of sustaining their injuries in an accident involving a self-insured defendant or a defendant insured by a non-resident foreign insurer or reinsurer are unlikely to have the benefits of a structured settlement agreement made available to them because of either the perceived inability of those parties to structure a settlement agreement under the present method or the actual cost effect to them of directly performing the role of a resident insurance corporation in a settlement agreement structured under the current method.

II. The New Method of Structuring Settlements

A. The Basic Structure

The perceived and actual inhibitions to the more widespread use of structured settlement agreements arising from both the technical application

of the Income Tax Act to and the cost of the administration of structured settlement agreements made it apparent that it would not be a sufficient solution merely to achieve a confirmation in an advance income tax ruling that the phrase "casualty insurers" was not restricted in meaning to only insurance corporations. The only effective solution that was identified as eliminating the perceived and actual problems for self-insurers, non-resident foreign insurers and reinsurers, insolvent insurers and all other insurance corporations arising from the present method of structuring settlement agreements was to isolate them from the aspects of the performance of structured settlement agreements which attracted the adverse consequences. The solution identified was to enable the insurer to assign to another party more suited to coping with those consequences the performance aspect of the structured settlement agreement which attracted the problems. The assignment of the performance of the structured settlement agreement became the concept underlying the new method of structuring settlement agreements.

In developing the new method of structuring settlement agreements for the purpose of obtaining the Ruling it was an important consideration to incorporate in it those non-tax oriented criteria designed both to avoid possible future abuse or misapplication of the ability to assign structured settlement agreements and to satisfy plaintiffs and their counsel of the fiscal security of the assigned arrangement.

The new method of structuring settlement agreements used as the model in the case in respect of which the Ruling was obtained is based on the following criteria:

- (1) The plaintiff and the insurer enter into a settlement agreement requiring periodic payments to be made to the plaintiff for a specified term in respect of a claim for damages resulting from personal injury or death.
- (2) The insurer, with the consent of the plaintiff, may make a conditional assignment to an eligible assignee of its rights and obligations in relation to the settlement agreement entered into by it with the plaintiff. The assignment is to specifically provide for the substituted performance of those rights and obligations by the assignee.
- (3) The plaintiff must consent in writing to the conditional assignment by the insurer to the eligible assignee in order to ensure the enforceability by the plaintiff of the substituted performance by the assignee, provided that the consent of the plaintiff must be expressly stipulated not to be or to be deemed to be or interpreted as being a novation of the structured settlement agreement.
- (4) The assignment is to be a conditional assignment in that if the eligible assignee fails to perform the structured settlement agreement, the assignment will cease to be operative in the sense that the liability of the insurer to perform the structured settlement agreement will cease to be contingent or conditional or secondary and will become primary and immediate.
- (5) To be eligible, the assignee is to be either an affiliate of the Issuer of the annuity contract to be acquired in relation to the structured settlement agreement, or any other entity which satisfies the requirements (financial or otherwise) to act

- as an assignee as may be established in the discretion of the courts, under any applicable legislation or otherwise.
- (6) If the entity which is to be the assignee is an affiliate of the Issuer, it is not necessary that the affiliate independently meet those financial requirements that may be established for it to be an eligible assignee. If those requirements are not met, then as an inducement both to the plaintiff to consent and to the insurer to enter into the conditional assignment, the Issuer is to guarantee, indemnify or assure, contingently or otherwise, to each of the plaintiff and the insurer the substituted performance by its otherwise unqualified affiliate as the assignee of the structured settlement agreement. The liability of the Issuer to the plaintiff and the insurer pursuant to the guarantee, indemnity or assurance must be expressly restricted to the substituted performance by the affiliate and neither of the plaintiff nor the insurer are to acquire any rights against the Issuer in, to or under the annuity contract itself.
 - (7) A nominal fee or premium is to be paid by the insurer as consideration to the eligible assignee for its assumption of the liability to perform the structured agreement pursuant to the conditional assignment. As part of the consideration the insurer will also fund the amount of the premium to be paid to the Issuer for the issuance of the annuity contract.
 - (8) Pursuant to the conditional assignment the eligible assignee, as owner and beneficiary, is to purchase a single premium, non-assignable, non-commutable and non-transferable annuity contract from an Issuer in order to fund its substituted performance of the structured settlement agreement. It will irrevocably direct the Issuer to make the payments under the annuity contract to the plaintiff and will otherwise comply with the provisions of the Bulletin.
 - (9) The tax treatment for the insurer is that, as a result of the assignment, it will not have acquired a direct interest in the annuity contract issued by the Issuer and will not have a direct future liability pursuant to the structured settlement agreement. The consideration paid to the eligible assignee represents a payment in respect of a current liability under the assignment agreement and is a deductible expense in the business of the insurer in the fiscal year in which the consideration is paid.³⁰ As the insurer has no direct interest in the annuity contract it is not required to include the payments under the annuity contract in a fiscal year in the calculation of its income for that fiscal year.³¹ Correspondingly, by reason of the assignment of the settlement agreement, it is not entitled to deduct the payments made under the settlement agreement in the calculation of its income for the fiscal year in which those payments are made.³²
 - (10) The receipt of the annuity payments by the plaintiff pursuant to the structured settlement agreement will remain, in the view of Revenue Canada, non-taxable as a payment for damages, notwithstanding the assignment of the performance of the structured settlement agreement by the defendant or its insurer.³³
 - (11) The eligibility to deduct a reserve and to obtain the "wash" effect for a structured settlement agreement pursuant to the provisions of the Income Tax Act must be established by the assignee for itself.

³⁰ Ruling, *supra*, footnote 2; Income Tax Act, *supra*, footnote 4.

³¹ Ruling, *ibid.*; Income Tax Act, *ibid.*, ss. 12.2, 56(i)(d).

³² Ruling, *ibid.*; Income Tax Act, *ibid.*, ss. 9, 18(1)(a), 18(1)(b), 18(1)(e) and 245.

³³ Ruling, *ibid.*; Income Tax Act, *ibid.*, ss. 3, 9, 56(1) and 245.

B. *Considerations Underlying the New Method of Structuring Settlements*

1. *Conditional Assignment*

In designing the new method of structuring settlement agreements a crucial consideration was the possibility that plaintiffs and their counsel might suspect that an assignment of the settlement agreement could be improperly used by an insurer to avoid liability under the structured settlement agreement. The provisions of the Bulletin also require that the insurer remain liable under the structured settlement agreement. To that end the criteria was established that the assignment itself be a conditional assignment as opposed to an absolute or legal assignment. A conditional assignment is an equitable chose in action and is an assignment which becomes operative or which ceases to be operative on the happening of an uncertain event.³⁴

The assignment agreement must stipulate that the assignment to the eligible assignee is to be conditional on its performance. The failure of that performance, for reasons of insolvency or otherwise, by the assignee is to result in the revival of the contingent, conditional or secondary liability of the insurer to perform the settlement agreement.

There is authority in Canada supporting the proposition that an assignment made subject to a condition precedent can be a conditional assignment.³⁵ Unfortunately, there is no Canadian case law to support the proposition that an assignment made conditional on a condition subsequent is a conditional assignment. Relying on the non-Canadian authorities and text writers, it was stipulated for the purposes of obtaining the Ruling that the assignment be conditional in nature. As an alternative, due to the uncertainty of the effectiveness of a conditional assignment based on a condition subsequent, it was also stipulated that the assignment agreement provide for the substituted or vicarious performance of the settlement agreement by the assignee and that the substituted or vicarious performance pursuant to the assignment agreement be consented to by the plaintiff.

2. *Substituted Performance and Consent*

The issue of whether the assignment of the performance of the settlement agreement can be considered to be a conditional assignment is further complicated by the issue of whether it would be viewed as the assignment of merely the burden and not the benefit of the settlement agreement. It is not possible to assign only the burdens of a contractual obligation.³⁶

³⁴ G.H.L. Fridman, *The Law of Contract in Canada* (2d ed., 1986), p. 628; G.H. Treitel, *The Law of Contract* (7th ed., 1987), pp. 502, 503.

³⁵ *Dominion Creosoting Co. v. Nickson Co.* (1917), 55 S.C.R. 303, 38 D.L.R. 69.

³⁶ Fridman, *op. cit.*, footnote 34, p. 634.

The commentators on this issue state that while the assignment of only the burdens of a contractual obligation is not permitted, substituted or vicarious performance of a contract may be allowed if no personal skill or confidence in the ability of the assignor is required in respect of the performance which is to be assigned.³⁷ In the circumstances of a settlement agreement, it is arguable that personal skill and confidence are expended in the negotiation of the settlement agreement by the insurer and its advisors, and that the assignee is merely a conduit to perform the results of the application of those skills and abilities as set out in the settlement agreement.

To eliminate any uncertainty as to the binding effect of the agreement, if it is to be interpreted as an agreement for substituted or vicarious performance, it was also required that the plaintiff consent to the substituted performance by the assignee. The consent can be viewed as an estoppel to any objection that could be raised by the plaintiff to the effect that the substituted performance is not possible as the plaintiff was relying on the personal skills and abilities of the insurer in performing the settlement agreement.³⁸ This consent should be set out in the documents implementing the assignment of the settlement agreement.

If the arrangement between the insurer and the assignee is more properly categorized as an agreement for substituted or vicarious performance, the contingent or secondary liability of the insurer is preserved both for the purposes of the Bulletin and the interest of the plaintiff in insuring the security of the structured settlement arrangement.

3. *Novation*

It has also been carefully stipulated that the consent by the plaintiff is only to the conditional nature of the assignment and the substituted performance by the assignee and does not constitute a novation. A novation would have the effect of making the settlement agreement an original agreement between the assignee and the plaintiff and result in the insurer not having a conditional, secondary or contingent liability.³⁹ The documents implementing the assignment of the settlement agreement should expressly provide that the consent of the plaintiff does not constitute a novation.

4. *Permitted Types of Assignee*

In establishing the broadly framed criteria for the types of entities which may be eligible to act as assignees of settlement agreements, the American experience was analyzed for examples that could be used in Canada. This analysis indicated that the following types of arrangements are presently in use:

³⁷ Fridman, *ibid.*, p. 634.

³⁸ Treitel, *op. cit.*, footnote 34, p. 573.

³⁹ Fridman, *op. cit.*, footnote 34, p. 620; Treitel, *op. cit.*, footnote 34, p. 498.

- (1) the settlement agreement is assigned to a sister corporation of the Issuer and the assignee then performs the settlement agreement;
- (2) the settlement agreement is assigned to the parent corporation of the Issuer and the assignee then performs the settlement agreement;
- (3) the settlement agreement is assigned to a subsidiary corporation of the Issuer and the assignee then performs the settlement agreement, provided that the performance of the agreement by the subsidiary corporation is guaranteed, indemnified or otherwise assured by the Issuer; or
- (4) the settlement agreement is bonded by an insurance company, unrelated to the Issuer, which accepts an assignment of the settlement agreement and issues a bond to the plaintiff guaranteeing the performance of the settlement agreement.

The fourth example presented difficult practical problems which did not appear to be capable of resolution and, accordingly, this possible type of assignment arrangement was discarded in structuring the settlement agreement in respect of which the Ruling was obtained.

From the analysis of the other three examples of the types of assignee in use in the United States, the criteria were developed which were incorporated into the model of the new method of structuring settlement agreements. Under the criteria, the assignee, to be eligible, must independently meet any financial criteria which may exist or, in the event it does not independently meet these criteria, its obligation to perform the settlement agreement is to be guaranteed, indemnified or otherwise assured by the affiliated Issuer which does meet these criteria. The non-financial criteria were also framed to acknowledge that further precise requirements could be established, either concurrently with the implementation of the initial assignment of a structured settlement agreement or in the future, by any of the authorities having the appropriate jurisdiction for the types of entities that may be permitted to act as assignees. The possibility also exists under the criteria as framed that the assignee could be completely independent of the Issuer if it independently meets the stipulated criteria.

Any guarantee, indemnity or other assurance by the Issuer or its affiliated assignee must be strictly limited to the performance of the settlement agreement. In effect the new method of structuring settlement agreements divides the second contractual relationship required by the Bulletin⁴⁰ into two separate contractual relationships. One of those relationships is established between the insurer and the assignee and the other between the assignee and the Issuer. As remains the case for the plaintiff, no direct contractual privity can be established between the insurer and the Issuer. The only exception to this general principle for each of the plaintiff and the insurer is the limited contractual privity established by the guarantee, indemnity or other assurance issued in their favour by the Issuer. If either of the plaintiff or the issuer were to acquire rights in respect of the Issuer in, to or under the annuity contract itself (that is, contractual privity),

⁴⁰ See the text, *supra*, p. 32.

then Revenue Canada would consider either of them, as the case may be, as having a direct interest in the annuity contract. This would result in all of the adverse tax consequences, for the insurer, with respect to the deductibility of a reserve and the availability of the "wash" effect of a structured settlement agreement and, for the plaintiff, in the loss of the desired tax effect. The guarantee, indemnity or other assurance of the Issuer should also provide additional evidence to plaintiffs and their counsel of the fiscal security of the settlement agreement as assigned and structured.

5. Formation and Tax Treatment of Assignee

The Ruling does not address either the requirements for the formation of an assignee or the tax treatment it would receive under the Income Tax Act in performing the structured settlement agreement. In connection with the case which gave rise to the Ruling these responsibilities for establishing these matters were assumed by the particular Issuer involved in the case. The Issuer in that case selected a subsidiary insurance corporation to be the assignee. It was clearly established in the Advance Income Tax Ruling⁴¹ obtained by Canadian Pacific Limited that the assignee was required to be an insurance corporation and that the conditional assignment agreement was to be a contract of insurance. If these requirements are met the assignee is able to deduct the reserve for its present and future liability under the assigned structured settlement agreement and obtain the benefits of the "wash" effect. The participation of the particular assignee insurance corporation in the conditional assignment was considered and permitted by the Office of the Superintendent of Financial Institutions for Canada. The entire conditional assignment of the structure of the settlement agreement arrangement was reviewed by the Ontario Insurance Commission and the Official Guardian for Ontario.

In connection with its review, the Ontario Insurance Commission stated its preference that the requirements to be met by an Issuer in order for it to be able to issue an annuity contract for the purposes of structuring a settlement agreement be that it is either federally or provincially registered and that it have at least \$25,000,000.00 in unappropriated surplus. These criteria were incorporated in the assignment of the structured settlement agreement in the case for which the Ruling was obtained in place of the unsubstantiated \$3,000,000,000.00 in assets and federally registered criteria.⁴²

6. Consideration for Assignment

The formulation of the nature of consideration to be paid by the insurer to the assignee for its assumption of the liability to perform the

⁴¹ As an internal policy matter the insurance corporation which obtained this Advance Income Tax Ruling decided not to consent to the publication of its identity.

⁴² *Supra*, footnote 10.

structured settlement agreement served two purposes. Firstly, the assignee is put in funds for the purpose of paying the premium for the annuity contract. Secondly, an additional nominal amount or premium is to be paid to the assignee. This was done to establish that the assignee is engaged in the business of performing structured settlement agreements with a view to earning a profit and, consequently, entitled to deduct the payments made under a settlement agreement as an expense incurred in a business undertaken for the purpose of earning a profit.

7. Performance of Settlement Agreement

Notwithstanding the assignment, the requirements for a structured settlement agreement as established by the Bulletin must still be met by the assignee and the Issuer in performing the structured settlement agreement in order to achieve the desired beneficial tax result for the plaintiff.

C. The Courts

In the, as yet, unreported decision of Montgomery J. of the Ontario Court (General Division) in *Kay v. Coffin*,⁴³ the matter in respect of which the Ruling was obtained, an assigned settlement structured within the criteria set out above was sanctioned as a permitted form of structured settlement agreement in Ontario. In that particular structured settlement the following criteria were observed:

- (1) The conditional assignment agreement was in the form of a contract of insurance.
- (2) The assignee was an affiliated insurance corporation of the Issuer of the annuity contract to be acquired for the purpose of implementing the settlement agreement.
- (3) The Issuer was to guarantee, indemnify or otherwise assure the substituted performance by the assignee of the structured settlement agreement.
- (4) The liability of the Issuer under its guarantee, indemnity or other assurance was to be expressly restricted to the substituted performance of the conditionally assigned structured settlement agreement by its affiliated assignee. It was also expressly stipulated that neither the plaintiff nor the insurer were to acquire any rights against the Issuer in, to or under the annuity contract itself.
- (5) The Issuer was federally registered and had at least \$25,000,000.00 of unappropriated surplus.

D. The Benefits of the New Method of Structuring Settlements

The benefits of the new method of structuring settlement agreements are as follows.

⁴³ Released February 6, 1991.

1. *For All Insurers*

The ability to assign the performance of a structured settlement agreement, including the acquisition of the annuity contract and the responsibility to make all payments pursuant to the settlement agreement, is available to all types of insurers. As the annuity contract will be acquired by the assignee there will no longer be a requirement for an insurer to include the annuity contract as an asset on its balance sheet. Similarly, as the responsibility to perform the structured settlement agreement rests with the assignee, no insurer will have to record the settlement agreement as a liability on its balance sheet. The resulting distortion of the balance sheet for all types of insurers entering into a settlement agreement that is to be structured can therefore be avoided. All insurers availing themselves of the ability to assign the performance of structured settlement agreements will have to footnote their contingent, conditional or secondary liability under the assigned structured settlement agreement on their financial statements.

As the payments received under the annuity contract are notionally received by the assignee and the payments made under the settlement agreement are made by the assignee, the record-keeping requirement and the associated expensive administrative costs for all insurers using the new method of structuring settlement agreements will be borne by the assignee.

2. *Self-Insurers*

The Ruling clearly establishes that a self-insurer, such as Canadian Pacific Limited, may enter into a settlement agreement which can then be assigned and structured.

There is no longer any need for a self-insurer to consider performing the role of an insurance corporation in relation to a completely structured settlement agreement and attracting to itself the adverse tax consequences associated with its performance. All that is necessary for a self-insurer or other type of insurer under the new method is that a settlement agreement be effected which then can be assigned to an eligible assignee. For the assignee to be eligible it must have the ability to deduct a reserve and qualify as being engaged in the business of insurance with a view to earning a profit so as to achieve the benefit of the "wash" effect of a structured settlement agreement within the concepts established by the Bulletin and the Income Tax Act. It must also meet any other requirements for an assignee established by the courts or by any other appropriate authority. Accordingly, it is not necessary for a self-insurer to be concerned as to whether it would be eligible to deduct the reserve or to qualify for the "wash" effect.

3. *Foreign Insurers*

Similarly the recognition implicit in the Ruling that the new method of structuring settlement agreements separates the creation of a settlement agreement from the tax effect of its performance through its assignment to, and subsequent structuring by, the assignee also means that there is no longer any question of any perceived or actual fiscal impediment to the use of structured settlement agreements by nonresident foreign insurers or reinsurers. The nonresident foreign insurer or reinsurer need only enter into the settlement agreement which conforms to the requirements of the new method of structuring settlements. Once assigned the performance, after its structuring, of the settlement agreement by the assignee results in the payments under the annuity contract being legally received by a resident of Canada. The withholding tax provisions of the Income Tax Act⁴⁴ will not be applicable in the circumstances of a settlement agreement assigned by the nonresident foreign insurer or reinsurer to a resident assignee to whom, as a legal matter, the payments under the annuity contract are made by the resident Issuer.

4. *Insolvency of Insurers*

The significant aspect of the Ruling is that it clearly recognizes that a settlement agreement may be assigned by the insurer before it is structured and performed. Although it is not expressly stated in the Ruling, it is clear from its effect that the intended application of the provision of the Bulletin stipulating that the annuity contract be non-assignable, non-commutable and non-transferable is solely in relation to the plaintiff.

The effect of the Ruling in relation to settlement agreements that are implemented in the new method is to isolate the performance of the structured settlement agreement from any insolvency of the insurer. This effect creates the possibility that existing structured settlement agreements may be assigned, even if only partly performed, in the event of the insolvency of the casualty insurer. Another beneficial effect of the new method of structuring settlement agreements is that it will eventually result in a number of entities which are created solely for the purpose of the substituted performance of conditionally assigned structured settlement agreements and which, ostensibly, would be available to assume the responsibility of performing structured settlement agreements of those insurers which have become insolvent.

Conclusion

The new method of structuring settlement agreements sanctioned by the Ruling eliminates the actual or perceived impediments which now exist

⁴⁴ *Supra*, footnotes 28 and 29.

in relation to the use of structures of settlement agreements for self-insurers, nonresident foreign insurers and reinsurers and the cost factors associated with the administration of structured settlement agreements for all insurers, including insurance corporations. It will also facilitate the practical operation of the provisions of section 129 of the Courts of Justice Act⁴⁵ in Ontario. Assuming its acceptance by the courts, insurance regulators and other appropriate authorities of the other provinces, the new method of structuring settlements will result in the beneficial effects of structured settlement agreements and, when possible through legislative enactments, of structured judgments being made available to all plaintiffs throughout Canada notwithstanding that the defendant is a self-insurer or that the only party available to structure a settlement agreement is a nonresident foreign insurer or reinsurer.

⁴⁵ *Supra*, footnote 9.