Is there an advantage to regular payments?

Recent cases have highlighted a claimant's attitude towards risk and the indexation of payments. Stephen Ashcroft investigates

PERIODICAL PAYMENT ORDERS (PPOs) have been making the headlines over the past 12 months or so with the issue of indexation and the decisions in the *Thompstone* cases (see [2008] *SJ* 22 January, 5). It is hard to argue against the logic of PPOs; they replace the losses as they arise, are guaranteed for the lifetime of the claimant, and ensure that a claimant is neither over- nor under-compensated.

Historically, such arrangements were consensual in that both parties had to agree. The defendant insurer typically purchased an annuity from a Life Office, which was then owned by the claimant, and the insurer could close its books. In cases where the defendant was a government body – clinical negligence, for example – self-funding was the preferred option.

The Courts Act 2003 granted courts the power to impose PPOs, coupled with detailed "guidance" in the form of CPR41, as to when and how this power should be exercised. The aim was to encourage more cases to be settled by PPOs, in the hope that this would become the norm for future losses, rather than the exception. In essence, PPOs transfer the risk of providing for future care to the defendant/insurer, who, it was argued, is better placed to bear those risks than an individual claimant with their once-and-for-all damages award.

Viewed objectively, it is hard to argue against the logic of periodical payments to compensate for future losses. However, two other factors need to be taken into account – indexation of the payments and the claimant's attitude to risk. Both of these issues have been brought sharply into focus over the past year or so by the cases of *Thompstone et al* and *A v B*.

The Court of Appeal judgment in the *Thompstone* cases was handed down on 17 January 2008, and, as widely expected, dismissed the appeals of the defendants against the first instance findings of PPOs linked to ASHE 6115, rather than the Retail Price Index (RPI). Just as with the concept of periodical payments, it is hard to argue against carers' wages being linked to an earnings-based index. Historically, earnings inflation has consistently outstripped price inflation, so it is not surprising that, as a sub-group, carers' earnings (as represented by ASHE 6115) have also increased at a faster rate than the RPI.

The effect of tying the periodical payments awarded to meet a claimant's future care costs to the RPI would lead to a growing (and costly) disparity between the payments being made under the order and the actual cost of providing that care.

However, the issue is not purely one of cost; it is about providing an award that is "fair and reasonable" in the words of Swift J, in *Thompstone*. For a claimant, it is largely irrelevant whether ASHE 6115 outstrips the RPI, or vice versa. A claimant's concern is that the care they need, as a result of the negligence, is properly provided for by the defendant. A properly indexed PPO can largely be said to address that concern.

Culture shock for insurers

One further knock-on effect of the decision in *Thompstone* is that, while government bodies such as health authorities are reasonably well equipped to deal with the consequences of *Thompstone*, this will come as something of a culture shock for insurers.

Most insurers, when presented with a PPO, have chosen to "lay off" their obligations to make the future payments by the purchase of an annuity from a Life Office. This was because, prior to *Thompstone*, most PPOs were linked to the RPI, and there were annuity products available based on increases in the index.

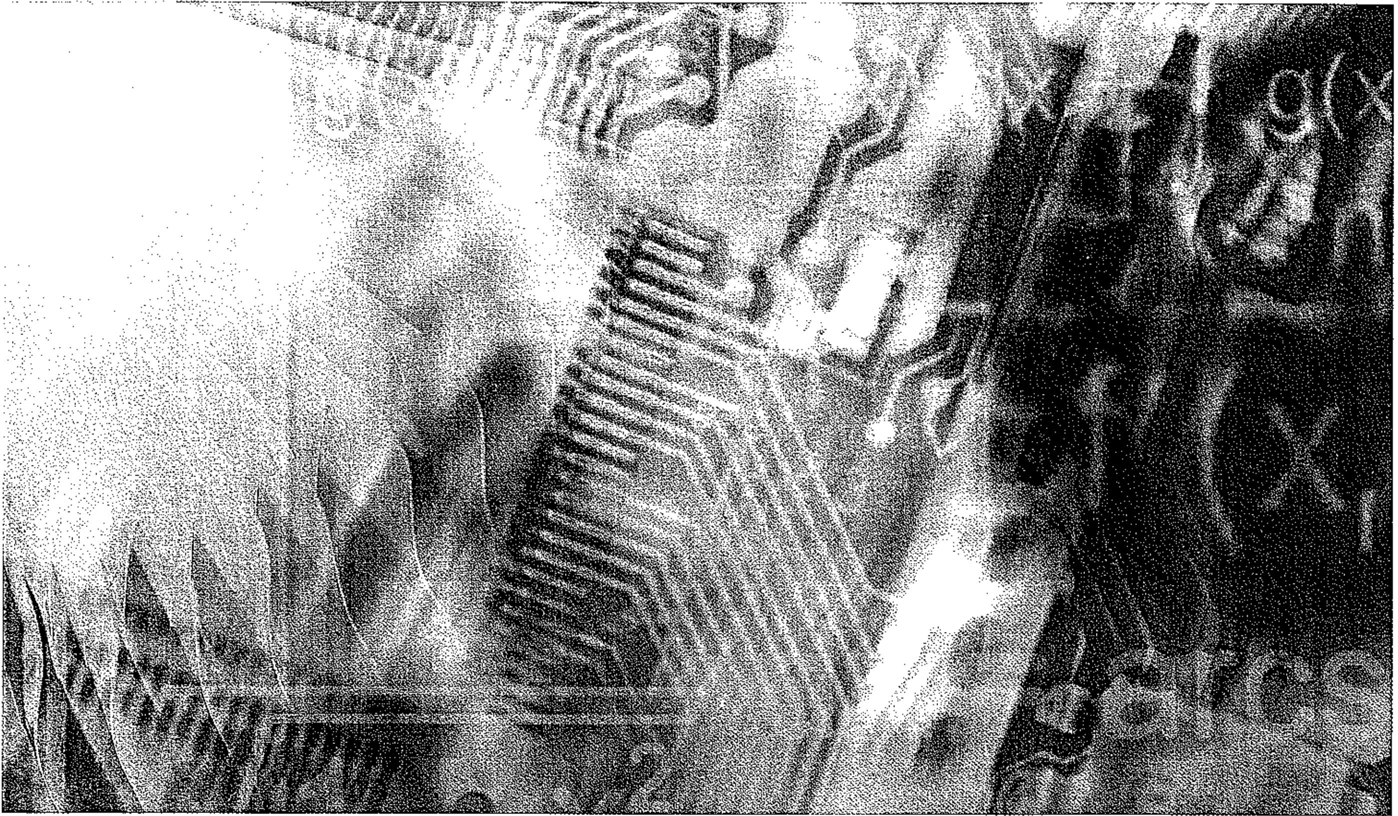
That is no longer the case following *Thompstone*. There are no products available in this market that are linked to any earnings-based index, let alone ASHE 6115, and nor are there likely to be any in the foreseeable future. As a consequence, insurers faced with a PPO linked to ASHE will have no alternative but to self-fund the future payments.

While not particularly desirable, composite insurers have the ability to hand over a sum of money to their asset management arm for long-term investment. Standalone liability insurers do not have that option and will need to devise a different, long-term strategy to meet the particular demands of an ASHE-linked PPO. In effect, insurers will be compelled to run a "defined benefits pension scheme" for its PPO claimants at a time when most institutions are closing them down!

Lump sums still preferred

While the decision in *Thompstone* will undoubtedly increase the attractions of PPOs for claimants, it remains the case that, in the majority of cases, lump sum settlements are still the preferred method. This was illustrated in the case of *A v B*, where the defendant, unsurprisingly a health authority, was urging for settlement on a periodical payments basis, while the claimant's family and advisers preferred a lump sum.

The investment risks inherent in lump sum settlements were examined, and historical data on equity returns was used. The family had expressly stated that they were familiar, and comfortable, with the risks of investment returns, but preferred the flexibility of a lump sum over the rigidity of a PPO. The court found in favour of the claimant, and the case settled on a lump sum basis.



It is self-evident that if costs of future care are awarded on the basis of a discount rate based on an assumed rate of return of 2.5 per cent – after tax and, importantly, after inflation – then if care costs rise at a greater rate than inflation, the money will run out. The only way that the monies are likely to last is if the investments perform better than the assumed rate. While, as we are constantly reminded, past performance should not be taken as a guarantee of future performance, there is a raft of historical data which can be referenced.

The Barclays Capital Study, published since 1956, contains a wealth of data on different asset classes, such as equities, cash and gilts, dating back more than 100 years. This shows not only actual performance, but also quantifies the likelihood of out- or underperformance of the different asset classes against each other. Thus, the probability of achieving any given rate of return can be calculated by reference to historic returns. So the question, often asked in settlement conferences, of "how much money will I need?" is the wrong one – that amount will be determined by reference to the multiplier/multiplicand system. The correct question should be "what rate of return will I require from my lump sum, and how likely am I to achieve that?"

It is vital that a proper analysis of all the options is undertaken prior to settlement. It is not always simply a choice of lump sum or PPO. It is important to retain a balance between the undoubted benefits of a properly indexed PPO – secure, tax-free income with virtually no risk – against the flexibility and investment opportunities offered by lump sum investments. It is possible to have a PPO for part, rather than the whole, of a head of damage, to retain flexibility.

It should also be remembered that, where a lump sum settlement is preferred, the facility still exists for a structured settlement on a "top-down" basis. Many practitioners are still under the impression that the new periodical payments regime replaced the structured settlement system. That is patently not the case. Although conventional annuity rates remain at relatively low levels, the ability to guarantee tax-free income can play an important part in the overall investment portfolio.

Structured settlement annuity

There is also the option of the structured settlement flexible annuity. This is a tremendous product that suffered on its launch more than three years ago from a campaign of misinformation and disinformation which adversely affected sentiment towards an attractive and innovative solution for recipients of personal injury awards. It gives a claimant the ability to ring-fence tax-free income for the rest of their life, to choose (within policy limits) the level of that income and to review income levels on a regular basis, while retaining investment control over the money.

One major added advantage is that unlike PPOs, the balance of the investment is returned to the claimant's estate on death. While not a direct comparator to periodical payments, the tax-free nature of them can play a significant part in ensuring that the award will last for the claimant's lifetime.

The award in a maximum severity case is a once-and-for-all settlement, and is designed to ensure that a severely injured claimant's needs are met for the rest of their life. It is no longer enough merely to value a claim in monetary terms to determine whether it was a "good" settlement. Proper evaluation of all the options open to a claimant should be seen as a pre-requisite, when considering the overall success, or otherwise, of a claim.

◈ Stephen Ashcroft is a director of Frenkel Topping Ltd, financial advisers specialising in the investment of personal injury awards