Are Management Fees Necessary for Today's Court Awards?

by Geoffrey Young

In several recent cases the B.C. Supreme Court has refused to allow the cost of professional fund management as part of an award to an injured person, or has set low management cost awards. The Courts have apparently accepted an argument that an allowance for fund management (as opposed to simple caretaking) is not required with a fund invested in fixed-interest instruments because the 3.5 percent real return foreseen by the Law and Equity Act (R.S.B.C. 1979 c. 224, s. 51) regulations can be achieved with simple bond investments that do not require continuing professional investment advice. The Courts have also held that such professional advice would increase the return above the "target" rate of 3.5 percent (paragraph 29 of West v. Cotton [1995] B.C.J. No. 1710; 10 B.C.L. R. (3d) 74 (B.C.C.A.), paragraph 102 of Macdonald v. Neufeld (1993), 85 B.C.L.R (2d) 129).

Current Status

The current state of the law is reflected in a recent decision, Robulak v. Heidecker, (16 April 1998) Vancouver B950669 (B.C.S.C.), where the Court refers to the Appeal Court decision in West v. Cotton, supra, at paragraph 30 in finding that "the discount rate used in the calculation of the present value of various heads of damage is premised on the use of very conservative investments to obtain the required rate of return". The Court consequently awarded only the present value of a relatively modest amount for accounting and tax-filing services.

The decision of West v. Cotton, in turn, summarizes previous findings. At paragraph 31 the Appeal Court reduces an award of $183,000 for investment "management" services to $50,000 for "accounting advice" (paragraph 31). The Court, in summarizing "the law as it now stands", suggests "that the discount rates adopted by regulation under the Law and Equity Act, R.S.B.C. 1979 c. 224, s. 51, are predicated on the investment of awards for future care and loss of future earning capacity in interest bearing government bonds, or similar secure bank or trust company investment certificates, and do not contemplate the need for dividends or capital gains in order to achieve the required annual payments from the assumed self-liquidating fund." (paragraph 30).

The basis for this finding is not entirely clear. Neither the Act nor the Regulations discusses the type of investment foreseen, so it appears that the Appeal Court is interpreting the findings of previous cases before the Court rather than indicating the intent of the legislation. For example, in its West decision (at paragraph 29) the Court refers to Unrah vs. Webber [1994] B.C.J. No. 467 as a case dealing with "the law as it now stands". In Unrah the appeal Court agrees with the trial judge's finding that the fund for future care could be invested entirely in bonds and still earn the "2 and 3 percent net return [presumably this should read 3.5 percent] on investment established by the statute...". "It follows naturally from that conclusion [the Court finds] that there is no need for an allowance for 'portfolio management' for the reason that such bonds can readily be purchased without commission, and without engaging the services of any stock broker or 'portfolio manager'"(Unrah, paragraph 75). The appeal Court does allow for $3,500 per year for accounting advice.

Previous Findings

The evolution of the Court's treatment of fund management fees can be traced in earlier cases. In Macdonald, for example, the trial judge has evidence in front of him that $292,000 is required for management for a head-injured young person, but awards only $40,000. Although, according to the Appeal Court, this is the only evidence at trial with respect to the cost of investment counseling, the trial judge says that he has assumed that the plaintiff had only to search out competent financial advisors. He says nothing need be allowed to cover the fees of such advisors because they ought to be able to cover their fees by the return [over 3.5 percent in real terms, presumably] they were able to make on the fund. "If they can't earn their keep, they are replaced" (paragraph 96).

In Macdonald, the Court has cited Cherry v. Borsman [1991], 70 B.C.L.R (2d) 273 and Shaw v. Storey [1989] B.C.J. No. 674, and appears to be relying on evidence presented in those cases in their findings. In Cherry the appeal argues that the management fee is excessive in that it will allow the plaintiff to achieve more than the 3.5 percent real return prescribed in the Act, and thus create an estate. The Court says "the uncontradicted expert evidence on the defendant's side is that the expected real rate of return on investment after taking into account the fees which are paid to money managers should exceed 3.5 percent." Presumably this evidence consisted of statistical data or econometric studies describing the pattern of returns on various kinds of investment over long periods of time, corrected for inflation rates.

It is worth stressing that the evidence presented in Cherry was to demonstrate (1) that professional fund managers should be able to achieve the target rate after paying their fees, not (2) that non-professional plaintiffs can achieve the target rate without a fund manager's advice. The first proposition does not imply the second, although it is possible that this has not always been clear.

In Shaw, the trial judge awards only $1,000 per year for money management, based on the finding that the victim should not require more than the periodic assistance of an accounting advisor in managing the fund. The Court observes (last paragraph on page 8) that "...the return at present available is about 7 percent per annum above current inflation - or twice the return contemplated by the statutory discount rates". It is not clear from the judgment what evidence was before the Court in making this finding. Importantly, the judge indicates that he is aware that his finding applies only to current interest and inflation rates; the extra return during the initial investment period is to "cushion" the fund in any later period when the real rate of return falls. The judge understands the shifting nature of real rates of return, but does not enter into any mathematical calculation of whether in fact the rate of return over the life of the fund (the plaintiff was only 27) will meet the target rate.

Gross-up for Taxes

In both Shaw and Cherry a separate but related issue, the amount of gross-up for income taxes on the cost of care component, is introduced. The appeal Court notes that a bond portfolio, not eligible for the favorable tax treatment of Canadian dividend income, requires a higher allowance to offset the income taxes the recipient will have to pay. Thus the lower management fee required of a bond portfolio, the Court says, is somewhat offset by the higher tax gross-up required.

An Economist's View

It is noteworthy that in the cases we have cited, Court findings were made in the context of either a complete lack of evidence, or uncontradicted evidence presented by one side. Perhaps because of the evolving and uncertain state of the law, together with the considerable expense of obtaining expert evidence on what is usually a relatively small component of an award, it does not appear that in any of the influential cases evidence for and against the need for management fees, based on the probable return to investment with and without expert advice, was systematically laid before the Court.

As an economist I understand why the Courts over recent years appear to have concluded that fund management advice is not needed. Investments in government bonds have usually achieved the 3.5 percent target rate over the last few years. I do not agree, however, that the rate is certain to be exceeded in the future. The results of the last 15 years, I suggest, are not typical of the experience of the last 40 years. A fund established now may have to be maintained for two or three decades over the period of a young person's working life, and experience of two decades ago may be just as relevant to the future as the experience of the last few years.

The early 1980s was a period of very high interest rates that was followed by a period of declining inflation. At their peaks in 1982, three month Treasury Bills were yielding 20.8 percent, long term Government of Canada bonds were yielding 17.7 percent and savings deposits were paying 19 percent. Inflation fell slowly from its 1981 peak of 12.4 percent [1] to about 10.9 percent in 1982, and then fell far more quickly than most investors had expected, to less than 6 percent in 1983

and under 5 percent in 1985. For several years thereafter inflation fell below expectations, and indeed has continued to decline. The result was that all investors in interest bearing securities did well in the early and mid-80s, while those who invested in longer term instruments achieved spectacular returns over longer periods.

Some of the Court decisions we have cited appear to envision a naive plaintiff who, absent professional advice, implements a simple strategy of investing his award in safe government bonds. Figure 1 is based on our interpretation of what the Courts might mean by this. It shows the return realized over a 10 year period on a fund invested entirely in Government of Canada bonds with a maturity of 10 years. The graph shows the history of real (after allowing for inflation) returns actually realized (that is, looking back after 10 years have elapsed) when the fund is being wound up. Figure 1 also shows the return on a fund in which the investor places the entire award in 90 day Treasury Bills and continually reinvests the proceeds for 10 years. Obviously we cannot be certain what will actually be realized on funds invested more recently than 10 years before the date of this writing, but we have forecast results for a short period into the future based on "high return" and "low return" possibilities.[2]

Looking back from the 1990s to see what people investing in the 1980s achieved, one would observe a real return on 10-year bonds ranging from about 5.5 percent up as high as 12 percent (depending on the year), but always well above the target rate and averaging over 7 percent. Most of the Court decisions we have cited date from this period.

Looking farther back in time the picture changes, however. Investors in 10-year bonds during the mid-60s and early 1970s, a period of low rates destined to be followed by a period of accelerating inflation, realized dismal real returns (bottoming out at a 1972 investor's minus 2.8 percent, which saw him in 1982 rewarded with a substantial loss in purchasing power). An award recipient in any of the years of the decade from mid-1963 to mid-1973 who simply invested his entire award (and reinvested interest) in three-month Treasury Bills would have ended up 10 years later with a real return that was no higher than 1 percent per year, and which at worst was negative.

Obviously a number of other government bond investments are available, with returns generally falling between these two. Similarly, a more sensible mixed portfolio consisting of different maturities would fall between the two lines we have graphed.[3]

Most funds last for more than 10 years, and longer periods tend to reduce both risks and rewards, since reinvestment of maturing bonds will balance out the effects of high and low real rate periods. This is illustrated in Figure 2, where we show the experience of a hypothetical investor who purchased a 10 year Canada bond on receiving his award and then reinvested the proceeds on the maturity date for a further 10 years. Those who invested in this way in the 1970s (and, we forecast, in the early 80s) would generally have realized overall real returns above the 3.5 percent target rate. But looking farther back investors in the 1950s and 1960s would have realized much lower returns.

The graph also shows the experience of continual reinvestment in 3 month Treasury Bills. Thus, looking back to the mid- or late 1970s (and probably early 80s), an investor over 20 years would have seen real returns over 3.5 percent per year. In no other 20 year period beginning since 1955 was the target rate achieved, however. Real returns were often under 1 percent per year.

Our conclusion, then, is simply that the experience of the last few years is misleading as an indicator of probable experience over the long term, and that achieving the 3.5 percent real return foreseen by the Law and Equity Act, while maintaining low risk and reasonable liquidity, has not historically been easy without relying on equities or on bonds that are more speculative than

government bonds.[4]

What Should the Courts Decide?

We would not expect everyone to agree with our conclusions. There is an enormous range of assumptions that can be made about the kinds of investment that a typical award recipient would invest in the absence of professional advice and about the future performance of those investments in the light of history. This is a fruitful field for economists, since the decisions of the Court would be based on the same kinds of evidence as would have been introduced if the choice of discount rate were an issue.

The Appeal Court in Cherry, supra, (paragraph 88) notes that evidence suggesting that the real rate of return is below the Law and Equity Act regulation figure, put forth to justify a higher award, would be rejected by the Court because it conflicts with the regulation. The Court thus suggests that evidence suggesting the contrary (that real rates are higher than the prescribed figure) should not be used to help a defendant and should be rejected. While this perhaps misinterprets the purpose of the evidence [5], in its finding, by implication, the Court is taking the very sensible view that it does not want to see re-fought, in argument over the level of management fees, the same battles over the real return on investment that the Law and Equity Act provision was designed to end. The entire purpose of the Regulation would be defeated if evidence on the real rate of return had to be brought forward in every case in order to determine an appropriate management fee. This note itself is an example (much compressed) of the kind of evidence we are likely to see presented. Much as it would be to the advantage of economics experts, this is not the result intended by the legislation.

There are certainly some issues that still may be worth exploring; for example, the regulation setting the real rate of return above wages at 2.5 percent assumes a real increase in wages and salaries of 1 percent a year, which may be questionable. The question of whether experience over a long period demonstrates that a managed fund is likely to achieve the target rate after management fees is still open.[6]

Although we note that even if the Court is satisfied that this test has been met, it must also be satisfied that an untrained plaintiff, in the absence of a management award, will recognize he must hire and pay professional managers to achieve his target rate of return.

But the Courts are probably not the place to deal with these technical issues. The Law and Equity Act regulations prescribing discount rates have saved countless hours and dollars that would otherwise have been spent endlessly examining the rate of return available on investments; it would be unfortunate if the issue were reopened in the context of management fees. Far better, perhaps, to require the Courts to determine the type and level of assistance the plaintiff requires, but then use simple calculation tables, such as those proposed by the Law Reform Commission[7], to determine the amount required.

Advice to Plaintiffs

At this time the B.C. Court appears to be inclined against significant management fees for plaintiffs of normal capabilities. This issue will be worth refighting in the Courts in the context of a large claim for earnings losses.[8] In the meantime, plaintiffs, if resigned to small management fee awards, should at least ensure that tax gross ups on cost of care awards are calculated on the basis of a portfolio entirely invested in bonds.

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1. Annual average of CPI over annual average for previous year.
2. These figures assume investment at the rate prevailing at the beginning of each 10-year period on Government of Canada bonds of over ten years maturity (Statistics Canada data base CANSIM). (We have used the "over ten years" rate rather than the 5 to 10 year rate, which has averaged about 0.3 percent less, in order to ensure our conclusions are conservative.) Our conclusions assume the

compounding of reinvested interest at the initial baond rate, as would be achieved by purchase of a compound interest bond or a discounted strip bond yielding the prevailing rate of interest. We are also well aware that in the real world an award recipient would want to hold different maturities and would require a part of the fund to be in short term investments or cash to meet immediate needs. Thus we would expect both the variability of returns and the average return to be less than in our examples. The charts are based on data to October 1998. The "high return" forecasts assume inflation declining to zero over 12 months, long term bond rates growing by 1 percent at .1 percent per month, and short term rates growing by 1.3 percent at .1 percent per month. The "low return" forcasts assume inflation growing to 2.5 percent over 12 months, long term bond rates declining by 1 percent at .1 percent per month, and short term rates declining by 1.7 percent at .1 percent per month.

3. Obviously a fund intended to be drawn down over a number of years will necessarily contain investments with a range of maturities
4. Government of Canada real return bonds have been suggested as a way to achieve the target rate. These bonds produce an interest return that is net of inflation. It is very clear from the unpopularity of these bonds, however, that they are not an investment that a typical investor seeks out in the absence of professional fund management advice. Our own inquiries suggest that it is not one that is fully understood even by all professional financial advisors. More important, typically only one or two terms to maturity will be available from an investment dealer at any time, so that only a fraction of a fund could reasonably be invested in real return bonds in any case.
5. The evidence is being presented not to justify a higher discount rate but merely to demonstrate that the "target" rate prescribed by the regulation can be achieved without the help of fund managers. Indeed, as we have seen, both trial and Appeal Court judges have relied on some kind of evidence, however incomplete, in their findings that an unsophisticated bond portfolio will achieve the target rate of return.
6. We have done enough research in this area to be assured that it is worth further investigation. We used the TSE 300 Total Return Index, which is available from 1956, as a proxy for a "typical" investment portfolio. While, as we expected, long term returns usually exceed the target rate, it is easy to find ten year periods where the real return is below the target rate or even negative. Over 20 year periods we do not observe negative ruturns, but in many cases the return is below the target rate or does not exceed it by enough to pay management fees at rates typical of mutual funds or of professional portfolio managers.
7. Report on Standardized Assumptions for Calculating Income Tax Gross-up and Management Fees in assessing Damages, Law Reform Commission of British Columbia, 1994.
8. Particularly a large earnings loss claim combined with a small cost of care claim. Because a cost of care claim is entitled to a tax gross-up, and because the tax gross-up is larger with bond than equity investments, the tax gross-up on a large cost of care award that is to be invested in bonds will to some extent offset the lower management fee on the award.