



Deciphering the economic damages report for lost earnings

Discounted cash flows, earnings trajectories, present value of future earnings — it's enough to make your head spin

DAVINA LING

“This is one of those cases in which the imagination is baffled by the facts.”

– Adam Smith (philosopher and economist, 1723-1790)

You just received the expert report on economic damages from the economist hired for the case. Staring at the numbers that populate the report, it is common to experience a certain level of bafflement and puzzlement. How did the expert come up with those numbers? How would you, as an attorney, decipher and evaluate the report? In this article, we will discuss the framework that economists commonly use to estimate economic damages and in particular, we will go through a hypothetical wrongful termination case to illustrate the main points.

In interpreting economic damages, it is important to know that the exact economic impact will *never* be known with certainty. Specifically, in wrongful termination cases, the economic damages are found by taking the difference between prospective earnings and benefits (if the termination had not taken place) and the actual earnings and benefits (as a result of the termination). Since prospective earnings and benefits are counter-factual, they are estimated based upon a certain set of data and assumptions. In other words, the experts' ability to estimate the most likely outcome is entirely dependent upon information provided to them by attorneys. The results can change when the information provided

varies. Hence, as a rule of thumb, you should provide your expert with as complete a set of information as possible.

Provide a complete set of information

In wrongful termination cases, besides trial date and date of termination, the following is a list of typical information needed:

- Demographic information such as age, race/ethnicity, level of education, presence of any disability;
- Pre-termination employment information such as work experience, past employment record, pre-termination income history, overtime pay, employer paid benefits and the amount of employer contribution, union membership and union contract;
- Post-termination employment information such as severance pay, post-termination jobs, their corresponding pay, employer paid benefits, periods of unemployment, and expenses incurred at obtaining a new job;
- Any additional information regarding economic losses not covered above. Unemployment benefit, if mandated by the state, is often not considered as a source of mitigating income.

A hypothetical case

As an example, let's consider the following hypothetical case: The plaintiff is a 46-year-old, male construction worker, who was wrongfully terminated (due to

racial discrimination) on October 16, 2006. Since the termination, he had been unable to find work for four months. Prior to termination, he was earning \$40/hour with a schedule of pay increases as specified by the union contract. His next raise was due on January 1, 2007. His employer had contributed \$256/week to his medical insurance, \$140/week to an annuity, and an additional \$180/week to a pension. Hence, the replacement cost of medical insurance is approximately \$1,000-\$1,250 per month.

At his new job, the plaintiff's hourly rate was significantly lower than his pay on his previous job. His new employer would only contribute to his medical insurance, annuity, and pension after six months of employment. The trial date was January 8, 2008.

Given the trial date, any damages incurred before January 8, 2008, would be considered past damages. Hence we would calculate the differences between prospective earnings and benefits (if the termination had not occurred) and the actual earnings and benefits during the period between October 16, 2006 and January 7, 2008. Future damages could consist of the differences between prospective earnings and benefits (if the termination had not occurred) and the actual earnings and benefits on and after January 8, 2008. How far into the future we should include in the calculation is usually determined either by your discretion or by the plaintiff's past work his-



MARCH 2008

tory. In some cases, attorneys may determine the future time horizon for the damage calculation with the help of vocational experts. In other cases the employment and work history of the plaintiff could provide a reasonable estimate. For example, if the plaintiff in the past had typically remained with the same employer for two to three years before switching jobs, then we could argue that he would have stayed with his most recent employer for at least two to three years if not for the termination.

While most cases would involve only lost earnings and benefits, in some cases there could be additional damages involved, including costs of looking for a job and emotional or psychological damages. Emotional or psychological damages may sometimes be quantified by using the costs of treatment or the costs incurred in repairing these damages.

Discounting

In constructing the stream of future cash flows, we need to convert them back to today's value. In economics jargon, this is called *discounting* or calculating the "present discounted value" (PDV). The basis for discounting is the idea that one dollar in the future (or particularly, one dollar in two to three years in our hypothetical case) is worth less than one dollar today due to inflation and interest that could be earned. If I place the one dollar that I have obtained today in the bank, one year from now I will have one dollar plus interest. But if I only obtain the dollar one year from now, I will not have been able to earn the interest.

Most people would prefer to obtain the dollar today rather than tomorrow or one year from now. Given this principle, when we consider future cash flows, we need to convert them to the value today for evaluation purposes. Even though

economists may agree upon the importance of discounting, they may differ on the choice of the discount rate. Most discount rates are obtained by using the rate on treasury bills because they are typically considered as the safest financial instruments. However, if you look at the Wall Street Journal, there are treasury bills of varying time horizon from one month, three months, six months, two years, ten years... 30 years and so on.

If you are considering a two-year time horizon for calculating future damages, then there are several ways to select the discount rate. You may envision that the plaintiff would obtain the returns or lost wages at the end of each year. If that is the case, you may select the rate on a one-year treasury bill which is equivalent to the plaintiff investing a certain amount of money into the one-year treasury bill and obtaining the return after one year. Alternatively, dependent on the variation in rates of treasury bills that day, you may decide to take an average of the treasury bills rate as appropriate for the discount rate. The choice of discount rate depends on a certain level of discretion and discernment.

Similarly, picking the trajectory for the growth in prospective and actual earnings and benefits streams also requires discretion and discernment. The trajectory for earnings and benefits growth can come from a number of data sources. One of the most reliable sources could be the union booklet and contracts. In our case, we are considering a construction worker who often belongs to a union. Union negotiations and contracts determine the trajectory for earning and benefits increases. Furthermore, knowledge of the industry and the plaintiff's past earnings and benefits history could also provide some guidelines for projecting future earnings and benefits. Finally, the infla-

tion rate may provide the most conservative estimates for future earnings and benefits.

In this article, we have discussed the most essential elements in an expert report for economic damages. In most reports, the expert should state the assumptions that are used in the calculations clearly. For instance, what is the rate of discounting used? How are the trajectories of prospective and actual earnings and benefits calculated? What are the assumptions regarding growth rates in earnings and benefits? How do the experts support the assumptions used? What are the underlying rationales? The economic damages are then the sum of past and future damages. When meeting with your experts to go over the report, make sure that they explain how they obtain these numbers and what assumptions they use to come up with the estimates. The key is to use reasonable assumptions that are compliant with good common sense.

Davina Ling received her Ph.D. in Economics from Massachusetts Institute of Technology. She obtained post-doctoral training at Harvard University and University of Chicago, and holds a B.A. from Wellesley College. She serves as an expert witness and provides estimation of economic damages to law firms, specifically in cases involving personal injury, wrongful death, and employment issues.



Ling

She is currently the director for a research center and an assistant professor in Economics at California State University Fullerton (CSUF). She has numerous publications in peer-reviewed journals and books. For more detailed information, please visit her Web site: www.davinaling.net or visit her firm's Web site: www.econconsultants.com.