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**Compensatory damages in lost wages claims: The case for empLoyment trends adjustments**

*In December 2005, XYZ Corporation lays off Mary D., a 29 year-old female account manager. A short while later, she sues XYZ, claiming wrongful termination. The case is due to come to trial in January 2012.*

*Mary seeks to recover “past losses” – defined as her potential or alleged losses from the date of termination to the date of the trial. She also seeks to recover “future losses” – potential or alleged losses from the date of the trial forward. Mary claims that as a result of her termination she lost wages, as well as her “ability” to obtain and maintain comparable employment with comparable compensation for the remainder of her worklife years.*

*The point of departure for the analysis of Mary’s alleged lost wages claim is her prior earnings history, which is as follows:*



*Mary returned to the work force in January 2010, earning a salary of $35,000 per year. Further, job search specialists opine that Mary should be able to reach earnings comparable to her pre-termination compensation within four years of the date of trial, or by 2015.*

*The economic expert retained through Mary’s attorneys uses these figures as the basis for the estimation of Mary’s economic damages by projecting her pre-termination earnings in 2005, assuming annual increases of $2,000 from the date of her termination forward. The expert factors in her assumed new hire date and wages, in order to compute the amount claimed for past and future losses.*

*Is the claim accurate? Does it fly in the face of economic reality to assume that Mary would in fact have earned her 2005 wages plus “typical” increases from 2005 forward with 100% certainty? Or would she have been affected – like millions of others – by one of the most prolonged downturns in economic history? Does her claim represent fair compensation or a potential windfall?*

*The underlying questions are these:*

* + *How to properly estimate earnings losses?*
	+ *Is the economic environment pre- and post-termination a relevant factor to consider in the analysis?*
	+ *What role do unemployment statistics play in a case such as this?*
	+ *What role do unemployment statistics play when evaluating earnings post-termination?*

**The Relevance of Unemployment Trends**

Maintaining employment - and consequently the stream of earnings that is expected to accompany it - does not carry a 100% certainty. The probability that someone may face periods of unemployment or under-employment is an important factor in estimating lost wages and/or other compensation. Any analysis that involves the estimation of lost compensation, whether due to a wrongful termination claim, a claim of personal injury or a wrongful death matter, needs to incorporate the probability that expected earnings may not have occurred.

This is a factor of particular importance as the U.S. economy moves through times of almost unprecedented economic challenge. Despite some evidence of a turnaround – the Business Cycle Dating Committee of the National Bureau of Economic Research declared the recession that began in December 2007 “officially” ended in June 2009 – by many accounts, job recovery in the United States continues to be slow, even in light of the July 2011 jobs report.

One of the most astonishing characteristics of this most recent recession and its unprecedented slow recovery is not just massive job loss, but the continued and protracted unemployment of many workers who filed for unemployment compensation benefits. Particularly, 2008-2010 proved to be a period of high anxiety over job retention for millions of workers across all industries across the country, evidenced by the significant upward trends in unemployment experienced in all 50 states. According to many analysts, an average of 150,000 jobs need to be added every month in order for the unemployment rate to begin a downward trend and to show consistent positive signs of job recovery.

The risk of unemployment, however, is an always-present factor, not just relevant during periods of upsurge in the rate and the duration of unemployment. Estimations of lost wages based on equations that assume continuous, uninterrupted employment, and a steady earnings stream with 100% certainty will generally be incomplete and upwardly biased. Given the events of the recent years, and the current state of recovery of the U.S. economy, adjusting for the probability that employment and earnings have a less than 100% chance of occurrence is even more relevant.

Counsel retained by both the plaintiff and by the defense should consider the value of economic damages models that include adjustments for risk – and particularly give consideration to the unemployment trends of the last three years – as a key element in estimating lost wages for 2007-2010 and in the upcoming years.

**The Economic Environment and Recent Unemployment Trends**

The Business Cycle Dating Committee of the National Bureau of Economic Research declared on September 20, 2010 that the recession that began in December 2007 “officially” ended in June 2009. By many accounts, the 2007-2009 recession has been characterized as the deepest economic downturn since World War II, and the deepest on record since the Great Depression, particularly in terms of job losses.

Financial services firms that had been considered pillars of Wall Street were brought to their knees as a result of the collapse in the real estate markets, which led to widespread downsizing, restructuring, and bankruptcy of both large and small corporations across the country and across all industries. More and more workers both in private organizations as well as in government agencies and municipalities found themselves either unemployed, or forced into part-time arrangements or mandatory furloughs, or facing salary freezes.

At a two-year remove from the height of this most recent economic crisis, job loss and slow job recovery continue to be at the center of the political discussion and at the center of the controversy over recovery strategy.

The greatest increase in the rate of unemployment was experienced in 2009, with the unemployment rate for the U.S. economy almost doubling from 5.8 % to 9.3 % during the period 2008 to 2009. This upward trend continued in 2010, and, so far, 2011 has shown little or no signs of changes in the unemployment picture, with only the July 2011 jobs report providing any indication of a potential change in trends.

The following chart shows the historical rate of unemployment over the last 20 years for the U.S. as a whole and for selected states:



The upward trend in the rate of unemployment has been coupled with an equally disconcerting upward trend in the number of weeks spent in unemployment. According to the U.S. Department of Labor, Bureau of Labor Statistics, the average number of weeks unemployed increased from 19 weeks in 2008 to 29 weeks in 2009.

Statistics also show that certain industries have been more affected than others. The following chart shows statistics released by the U.S. Department of Labor, Bureau of Labor Statistics, regarding the rate of unemployment for certain industries:



According to these statistics, government workers have historically experienced the lowest rate of unemployment, while workers in the construction industry have experienced unemployment rates above the national average.

In all, the picture of the last three years is severe – unlike anything in recent memory. However, the recent years do not constitute the only time of positive unemployment rates. While the rate of unemployment varies across industries and states, even at levels of frictional unemployment (a level of unemployment that is considered necessary for continuous flow in the job markets) a certain percentage of workers will experience idleness and no earnings.

**Claims for Lost Wages Have Several Causes**

Claims of lost wages can arise as a result of several possible circumstances, for example:

* **Termination from Employment:** Suppose an employee is terminated either individually or as part of a broader reduction in force. Such a situation may lead to a claim of termination on the basis of discrimination. The plaintiff will likely claim lost wages as well as an inability to return to the pre-termination level of earnings and compensation.
* **Failure to Promote:** Suppose an employee was expecting to be promoted to a certain job title, but this promotion did not occur at the time when the employee was expecting it. Such circumstances may lead to an allegation of failure to promote. If the employee’s compensation would have changed as a result of the promotion, there will be a claim of lost earnings and other supplemental compensation tied to base wages or job title.
* **Personal Injury:** A physical injury – one that prevents an individual from being able to return to a pre-injury occupation, or limits the individual’s ability to earn pre-injury wages – is likely to provoke a claim for those lost and/or diminished wages.
* **Wrongful Death:** A claim of lost earnings and other compensation may arise as a result of an individual’s death due to a third party’s liability, whether related to an accident, medical malpractice or even a tragic accident. Beneficiaries or next-of-kin will cite the impact of the deceased’s lost wages on their ability to live a life comparable to the one they enjoyed before the death.

**The Aim of Wage Loss Analysis is to Account for Wages That Would Probably Have Been Earned**

The objective of an analysis of lost compensation analysis is to determine, within reasonable economic certainty, the accurate value of wages and fringe benefits that someone would have likely earned and received “but-for” a disruptive incident.

***A reasonable estimate of an individual’s lost wages and fringe benefits has to be based on the likelihood that such earnings would in fact have occurred.*** The opposite is also true. If earning the wages wasn’t a 100% certainty, then an adjustment has to be made – the amount of the award will have to be reduced.

Damages calculations are designed to consider the possibility that wages only have a probability – not a certainty – of occurrence. Ideally, accounting for the likelihood that earnings may not have occurred would be based on measuring attrition rates specific to the pre-incident organization, industry and occupation. Such information, however, is not often available, and an alternative to such measure is to be considered. The most typical approach to evaluating the possibility that projected future periods of employment will not occur, and therefore affect the expectation of earnings, is to look at historical data related to the rate of unemployment.

Predictably, there are differences in how to interpret the data. Economists conducting analyses of employment trends generally consider different dates and spans of time for the unemployment rate.

Some economists may argue that the “past damages period”, defined as the period from the earnings disruption incident to the date of trial, should not incorporate any adjustment for the possibility of unemployment. Other economists may consider that the average rate of unemployment over a 30-year span should be used as the best predictor of future unemployment on the basis that such period of time should capture enough business cycles to provide a reasonable adjustment. Some economists consider that the risk of unemployment should not be a component of the analysis implicitly assuming pre-incident earnings would have been “certain”.

Is this approach adequate? Consider the following scenario: Suppose an incident in 2007 caused a worker to be out of work during years 2008, 2009 and 2010. One approach would consider that the individual’s wages for those years would have occurred with 100% certainty.

Does that approach capture reality?

It does not.

Given what we know of the extreme nature of the 2007-2009 recession – how radically it differs from the period immediately before, and how it radically changed the employment landscape for 2008-2011 and possibly beyond – it’s clear ***that an accurate analysis requires that we take the recession into account.*** How could we not adjust for the fact that:

* The unemployment rate doubled in 2009.

* The rate of unemployment has not yet returned to “normal” levels (in spite of the fact that the recession has been declared officially over by the Business Cycle Dating Committee of the National Bureau of Economic Research).
* The rate of unemployment would not return to a steady level overnight, but will likely take a few years for the unemployment rate to “reverse” to something closer to its historical average.

**Adjusting the Claim to Account for Real-World Employment Realities Results in a Different Picture of Lost Wages**

The question, then, is this: How do we get the estimate of lost wages to conform to reality? ***How do we adjust for the probability that someone’s pre-incident earnings may have been hindered by some other external factors, even if the disruptive incident at the center of their claim would not have occurred?***  If we do not account for this possibility – and if the lost earnings claim stands unadjusted – then it may result in a windfall.

To illustrate how the adjustment process works, let’s return to our opening example, the case of Mary D. Remember the particulars: She is a 29 year-old account manager. She was wrongfully terminated in December 2005. Her case will come to trial in January 2012. The basis of her economic damages claim is her pre-termination earnings, which escalated from $42,000 per year in 2002 to $48,000 per year in 2005, with an increase of $2,000 each year.

She claims both past losses (from termination to trial date) and future losses (from trial date forward).

Again, it has been determined that the plaintiff could have obtained employment as of 2010, and could have earned wages of at least $35,000 per year.

(One additional detail: In order to keep the discussion simple, suppose no considerations are to be made with regard to jurisdiction, taxes, or any other adjustments that may be applicable and which could affect the projections. Such consideration varies by case jurisdiction and can significantly impact the ultimate equation for the calculations.)

How do we reasonably estimate Mary’s lost earnings?

*Approach 1: Ignoring the possibility of unemployment*

This approach only takes into consideration the fact that Mary D., the plaintiff, received $2,000 increases in each of the four years of employment prior to termination, and assumes that her employment, as well as historical increases, would have continued to occur with 100% certainty. Accordingly, Mary’s past increases are simply projected forward to the end of the damages period, resulting in the following projection:



*Approach 2: Adjusting for the risk of unemployment*

Incorporating the rate of unemployment into our estimate requires that:

* We review the available statistics for the past period.

* We also estimate what the rate of unemployment would be for future years - years for which data is not yet available.

The figures for 2006 through 2010 are drawn from Table 1, which reported the U.S. rate of unemployment back to 1991. An assumption has to be made to account for the possibility of unemployment in “future” years (2011 to 2015). The table below reports the unemployment rate that will be used in the estimation of Mary’s lost earnings, and it is based on the assumption that the rate of unemployment will not return to its “normal” levels overnight. Rather, given the current state of the recovery on the job front, the unemployment rate will likely slowly reverse to its historical normal levels. Further, according to recent commentary by the U.S. Department of Labor, it is expected that attritional unemployment will likely be considered to be 6%:



Applying these past and hypothetical future unemployment-rate figures, we arrive at the following adjusted estimate of what Mary D. might have earned during the post-termination and post-trial periods:



Now we factor in additional information. Keep in mind that the plaintiff found new employment in 2010 for $35,000 per year. Also account for the fact that job search specialists have opined that Mary would be able to reach earnings levels comparable to what she earned in her pre-termination employment within four years after the trial.

Once the plaintiff becomes re-employed, the calculation of earnings loss becomes a “net loss.” That is, since the plaintiff is earning again, allegedly at a lower rate than would have been the case if she had been continually employed, the losses are estimated as the difference between her pre-termination earnings and her post-termination earnings. Post-termination earnings are also referred to as “mitigating earnings”.

With all of these factors taken into consideration, a new projection of the plaintiff’s alleged lost earnings is developed. This new projection accounts for Mary’s new earnings and the opinion of the job search specialists, as well as the fact that the risk of unemployment is present for Mary’s post-termination employment. It would affect the estimation of Mary’s post-termination earnings in similar fashion as it would have affected Mary’s pre-termination employment and earnings.

The adjusted, and more complete, estimation of net lost earnings in Mary’s hypothetical case is as follows:



As can be noted, once it is considered that the plaintiff’s pre-termination employment did not carry a 100% certainty, and that the probability of unemployment also plays a part in the projection of Mary’s post-termination employment and earnings, a significant adjustment takes place both to pre-termination and post-termination earnings. The value of the impact on earnings depends on the levels of assumed potential unemployment risk.

By applying real-world unemployment figures and adjusting accordingly, this process has produced a radically different estimate of lost wages - $326,273, or 44.7% lower than the original claim of $590,000 that did not take into account either post-termination earnings or the relevance of unemployment risks.

**A Reasonable Estimate of Loss Earnings Needs to Account for the Economic Environment**

Our review of the hypothetical case of Mary D. demonstrates how an economist can arrive at two different conclusions regarding the value of a lost earnings claim, depending on the assumptions made regarding the impact of external factors and the likelihood of employment on the estimation of earnings.

Many external factors play a role in the determination of someone’s “but-for” earnings or compensation, and some of these factors are not quantifiable, or cannot be predicted with certainty. As a result, any projection of lost earnings represents only an estimate and should be constructed based on assumptions that capture the surrounding economic realities, as well as case-specific facts and information.

One key element in providing a reasonable estimate of lost earnings is accounting for the probability of realization of “but-for” (if the incident had not occurred) expected earnings. Incidents that lead to legal claims should not be considered as the only factor that could have potentially impacted the likelihood of someone’s expected earnings. Rather, the general economic conditions, the economic conditions of the particular industry and occupation in the pre-incident scenario, factors specific to the pre-incident employer as well as to the individual’s potential incidents independent of the claim, are to be considered in providing an estimate.

Economic analysis is generally conducted under incomplete and asymmetric information, and not all factors can be fully accounted for. Some predictions require a certain degree of speculation. However, some undisputed realities should be considered, as such information is available and is relevant. The realities of the employment landscape are to be considered, and when specific employment fluctuations affecting the individual whose earnings are to be estimated cannot be readily captured, publicly available statistics related to the unemployment rate should also be considered.

An estimate of lost earnings that does not take uncertainty into account fails to paint a reasonable picture.