



## **Calculation of Economic Damages in Wrongful Termination Cases**

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## Calculation of Economic Damages in Wrongful Termination Cases

The calculation of economic damages is an important aspect of most cases involving an employment termination. “Economic Damages” can be defined as the amount of monetary compensation required to make an injured person whole or to restore what an individual has lost as a result of an alleged wrongful act.

In general, it is the role of the economic expert to estimate the economic loss incurred by an individual as a result of an event or wrongful act. It is important to note that damages only come into play in these cases if the defendant is determined to be at fault. The trier-of-fact (judge or jury) ultimately will decide if the defendant is liable for the alleged wrongful act. For the purpose of calculating damages, however, liability is assumed.

In wrongful termination cases, there are two scenarios to be analyzed:

- 1) The “But-for” scenario – What would the plaintiff’s career path, earnings, and benefits have been if the alleged wrongful termination had not occurred?
- 2) The “Offset” scenario – What would the plaintiff’s career path, earnings, and benefits likely be given that the alleged wrongful termination did occur?

The economic damage attributable to the termination is the difference between the earnings and benefits expected to accrue to the plaintiff under these two alternative scenarios. Since the “But-for” and future career path of the individual are not known with certainty, damage analyses are based upon both facts and assumptions. Variation in the maintained assumptions often leads to dramatically different estimates of damages by opposing experts.

### But-For Earnings

The first step in calculating economic damages in a wrongful termination case is to estimate the “But-for” earnings. The basic premise of any wrongful termination case is that the individual would have remained employed at their former employer but for the alleged wrongful event. The plaintiff’s final base pay is often used as a basis for projecting post-termination earnings at the former employer. If enough time has passed since the termination, projected earnings of the plaintiff can also be based, in part, on the actual earnings of similar workers who were not terminated.

When the expected economic loss period extends beyond the present, predictions of future wage growth are necessary. There are a number of methods that can be used to estimate future wage growth. Labor economists often use historic wage growth of the plaintiff or other similar employees to project earnings growth. For example, average pay increases for similar employees at the plaintiff’s former employer, or more broadly, average wage growth statistics for individuals employed in the same

occupation or industry, in general, may be used. Alternatively, expected wage growth is sometimes based on labor market-wide wage growth statistics. The Social Security Administration periodically publishes historic and projected future wage growth rates for the entire U.S. labor force and is a commonly used resource for projecting future wage growth. These statistics measure general wage inflation across the entire labor force but do not capture the components of wage growth that accrue to an individual worker due to further skill development and job experience. These general statistics may also mask differences in wage growth rates across occupations and industries. Consequently, use of general wage statistics, in some cases, may provide a less precise estimate of anticipated wage growth for a particular individual, occupation, or industry.

An employee's total cash compensation package may also include "variable pay" (e.g., bonuses, stock options, commissions, and overtime pay). While future base pay is likely to be correlated with previous base pay, this assumption may be less reasonable for bonuses and other forms of compensation. Key questions to consider when determining whether to project bonuses and other forms of compensation going forward post-termination include: Are these payments reasonably expected to continue into the future or are they discretionary? Have commission plans or overtime opportunities changed? Have bonuses and stock options been provided to employees in similar positions who remained employed? In response to the recent economic downturn, many companies instituted short-term base pay freezes and reduced or eliminated discretionary bonus plans. Using 2005-2007 historic earnings to project growth in 2008-2011 might result in an overestimate of earnings, for example, while using 2008-2011 historic earnings to project growth in 2012 and forward might cause an understatement of total future compensation. Consequently, it is important to understand recent market conditions and potential changes to the firm's compensation policies when determining whether to project future income from these sources in the economic loss calculations.

#### Offset Earnings Generated from Alternative Employment

The next step in calculating economic damages is to determine what the plaintiff reasonably could earn from alternative employment. The resulting offset earnings calculation is a measure of the plaintiff's "earnings capacity" as viewed in light of their termination from employment. A plaintiff's "earnings capacity" is not necessarily the same as their actual post-termination earnings and the distinction is important in economic loss calculations. If a plaintiff retains the physical and mental ability to perform a new job at similar wages to the position lost, then their earnings capacity has not been permanently damaged by the termination. In these situations, economic losses are primarily due to the job displacement itself. In contrast, a plaintiff suffering emotional distress from a termination might experience a loss in earnings capacity if the emotional distress causes them to be unable to perform full-time work or return to work in their usual profession. A job loss may also result in a reduction in earnings capacity if the plaintiff's former position or occupation required a specialized skill that is no longer in demand in the labor market.

In some cases, a plaintiff's actual record of post-termination earnings may be the correct measure of their lost earnings capacity. However, this is not the case if the individual has not made an appropriate effort to find and obtain new employment. A plaintiff's effort to find and obtain alternative employment is commonly referred to as "mitigation". In order to successfully claim damages due to a termination, a plaintiff is required to demonstrate that he or she made a reasonable effort to "mitigate their damage" by seeking employment consistent with their skills and ability. It is not unusual for an individual to experience an initial spell of unemployment before obtaining a position at a new employer while they search for a new job. The compensation at a new employer after job displacement may be at, below, or above previous earnings. The magnitude of the initial earnings loss or gain can be influenced by the availability of jobs requiring similar skills and abilities in the plaintiff's local area and by the market pay for these positions compared to compensation at the former employer. How quickly an employee transitions to a new job can vary depending on the individual's education, employment background, skill set, occupation, industry, and general labor market conditions. In some cases, job market outcomes may vary by age and disability status as well.

In damage cases, the ultimate goal is to determine the economic loss directly attributable to the alleged wrongful act – in this discussion, a wrongful termination. When preparing the earnings loss calculations it is important to distinguish between potential losses associated with the termination and losses resulting from other events or other decisions made by the individual. For example workers who fail to actively search for a job after a wrongful termination will remain unemployed substantially longer than workers who regularly search for and apply for jobs. Because a plaintiff's damages are directly impacted by their post-termination earnings, damage issues in wrongful termination lawsuits often focus on a determination of whether the plaintiff's level of effort into their job search was reasonable and appropriate. Plaintiffs who choose to change occupations, go back to school, or decide to start a new business may appear to be actively working to mitigate their losses, but may choose to accept lower initial earnings in hopes of an uncertain future payoff. In cases where a plaintiff's effort to find new employment is not clearly directed to replacing their lost job, it is the job of the economist to estimate the earnings and employment outcomes the plaintiff might have obtained had they taken such reasonable steps.

#### Components of Mitigation Earnings and Data Sources

##### (1) Availability of alternative employment for mitigation purposes

The availability of alternative employment becomes relevant when a plaintiff alleges that, despite best efforts, he or she could not find another job. Government projections, industry outlooks, and private sector surveys are sometimes used to assess the availability of employment opportunities. With the growth of publicly-accessible job postings on job and employment search websites (such as CareerBuilder.com and Monster.com), it is also possible to gather specific and detailed information on the number of job openings in a particular occupation and geographic area. This information is insightful because it can show whether labor market opportunities were available to a plaintiff in the

local area of their job search. The extent to which a plaintiff did or did not apply for local, publicly-advertised jobs in their occupation may bear on a determination of whether they made a reasonable effort to mitigate their economic damages.

### (2) Duration of unemployment after job loss

Regardless of the availability of alternative employment, it typically takes time for an individual to find a new job. In cases where a plaintiff has not yet found new employment, or did not reasonably search for new employment, the expert needs to make an assumption about the likely duration of unemployment for the plaintiff while between jobs. The U.S. Bureau of Labor Statistics (BLS) collects data and reports statistics on the average unemployment durations in the labor force including data by age, gender, occupation, and industry. For example, the mean duration of unemployment in March 2013 was 36.5 weeks for women age 16 and over, while the median duration of unemployment was 19.2 weeks for this group. This data on unemployed job-seekers (the vast majority of whom became unemployed involuntarily) can provide benchmarks for estimating what “average” job search outcome are for others who may be similar to the plaintiff in a wrongful termination lawsuit.<sup>1</sup>

### (3) Initial wage loss and recovery after finding a new job

In some cases, a worker may find re-employment in a position that pays less than the amount earned at their former employer. A number of empirical studies, however, show that this initial “earnings gap” is typically temporary. The U.S. Bureau of Labor Statistics (BLS) captures a wealth of information on job search length and earnings recovery patterns through its Displaced Workers Survey. The BLS surveys displaced workers every two years to ascertain how much of a wage loss workers suffer after being displaced from a recent job. These studies focus on workers who lost jobs due to a company or plant closing, insufficient work or the elimination of a shift or position. These are typically workers in contracting industries who are likely to be the most severely impacted by a job loss. The most recent BLS data indicate that 56% of long-term displaced workers were reemployed in full-time jobs by the next survey date (an average of 18 months since the job displacement), and among those reemployed, 46% were earning as much or more at the new job than at the lost one.

### Benefit Losses

Evaluating economic losses in wrongful termination cases often involves examining more than just changes in cash compensation. The plaintiff may also lose fringe benefits as a result of the job loss. Fringe benefits provided by an employer may include medical coverage, dental coverage, retirement contributions, meal allowances and insurance. Not all employers provide the same types of benefits or contribute the same amounts on behalf of employees. Some employers require employees to share a portion of benefit costs. The Department of Labor reports information on the fraction of employers that offer various types of fringe benefits and the value of benefits relative to total compensation costs. This

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<sup>1</sup> <http://www.bls.gov/cps/tables.htm#charunem>.

information can be used to project the likelihood that the plaintiff's new job will offer comparable fringe benefits and how much those benefits may be worth.

An important fringe benefit to consider in the damage calculations is retirement benefits (including defined contribution plans such as 401k and profit-sharing plans, and defined benefit plans such as CalPERS). Although many jobs offer retirement benefits, the value of these benefits can vary across employers. Depending on the age of the employee, the length of employment and type of plan (defined contribution versus defined benefit), the loss in retirement benefits could be significant, and the precise value of loss can be complicated to calculate. A precise calculation of the present value of potential benefit losses requires general benefit plan information and individual-specific benefit statements.

#### Determination of Loss Period Length

If a plaintiff's compensation at a new employer has not yet recovered to the levels of the lost job, then the question becomes: How long is the economic loss expected to continue? There are a numbers of factors and key questions the expert should consider when determining how long to accrue economic losses post-termination in the damage calculations.

##### (1) The financial stability or health of the company

Is the company still in business? Have layoffs or a restructuring occurred since the plaintiff left the company? Does the plaintiff's former position still exist? If the former company or position held by the plaintiff no longer exists, then economic losses may end at the point in time when the plaintiff otherwise would have reasonably stopped working for the company.

##### (2) The likelihood the plaintiff would have voluntarily stayed with the company

How long would the individual have stayed employed at the company but for the termination? Was the plaintiff planning to move, go back to school, or change careers? Is job turnover, in general, high in this profession? Events but-for the termination that otherwise would have led the plaintiff to voluntarily leave the former employer should also be considered in the damage calculations. Job turnover rates and job tenure can vary significantly by industry, occupation, and over time. Job turnover rates also tend to decline with seniority at a given employer. Employees with only one or two years of seniority at an employer are unlikely to remain with the same employer for the rest of their careers. In contrast, employees with ten or more years at the same employer may be less likely to quit their jobs. BLS statistics on job durations and turnover rates can provide some guidance on expected lengths of employment.

##### (3) The expected work life of the individual

In some cases, damages depend on the expected work life of the plaintiff. In these situations, important questions to consider include: Is the individual near retirement? Are there health issues or other factors unrelated to the termination that may contribute to the individual's likelihood of leaving the

labor force? There are a number of published studies by forensic economists that measure work-life expectancy.<sup>2</sup> These work-life expectancy tables provide the number of expected remaining years in the workforce based on the gender and educational attainment of the worker. It is important to note that work life expectancy tables do not estimate the number of remaining years at any one employer.

### Present Value Calculations and Discount Rates

Earnings and benefit losses rarely occur at a single point in time and in some cases may extend years into the future. A damage award, however, is typically calculated at the time of trial. Because of inflation and interest, a dollar received today is not worth the same as a dollar received a year from now. Consequently, projected future economic loss streams must be converted to present value to determine the value of a damage award in today's dollars.<sup>3</sup> The date of mediation, trial or official proceeding is often used as the evaluation date or point of demarcation for determining past and future losses in employment litigation cases.

“Present Value” is the current dollar amount, that if reasonably invested today, would provide the plaintiff with the expected future income loss stream attributed to the termination. In present value calculations, economists typically use an interest rate tied to U.S. government securities, which are widely viewed as being risk-free. A risk-free rate will be a lower rate than, for example, a stock investment for which returns may be higher, but are also associated with a possibility of investment loss. It is appropriate in most employment cases to use the lower (risk-free) rate because the calculation removes the possibility (or risk) that income would not be replaced. In some cases where the projected income is, in fact, uncertain, it might be appropriate to incorporate risk into the present value calculations by using a higher interest rate. Mathematically, the higher the discount rate, the lower the projected value of the award in current dollars. The key question becomes – What discount rate should be used? This is often a point of variation and debate among experts.

When determining the proper discount rate to use, it is important to consider the time frame in question. In general, interest rates tend to be higher for longer time horizons. For example, the 10-year Treasury Bill rate was 2.17% in March of 2012, but during the same month, the 3-month Treasury Bill rate was 0.08%.<sup>4</sup> To account for variation in interest rates over different time horizons in a future loss calculation, it is helpful to use U.S. Treasury Strips (also called zero-coupon bonds). Strips separate the

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<sup>2</sup> Skoog and Ciecka, “The Markov Model of Labor Force Participation,” *Journal of Legal Economics*, Spring/Summer 2001 is one commonly used source.

<sup>3</sup> The formula for converting a future income or loss stream to present value is as follows:

$$PV = \frac{FV}{(1+r)^n}$$

where PV is Present Value, FV is Future Value, r is the discount rate and n is the number of periods.

<sup>4</sup> [www.federalreserve.gov/releases/h15/data](http://www.federalreserve.gov/releases/h15/data). Board of Governors of the Federal Reserve System, Select Interest Rates – H.15, Historical Data.

interest and principal components of Treasury notes and bonds and report the interest for various maturity dates. By selecting a strip rate by the maturity date of the loss, one can choose the rate appropriate to the time horizon being projected. For example, the rate for strips maturing in May 2014 (hypothetically, to estimate the first year of damages in present value) is currently 0.14%, and the rate for strips maturing in May 2015 (to estimate the second year of damages in present value) is 0.24%.

Some economists find it expedient to combine projected future wage growth rates and projected discount rates together into a single number called a Net Discount Rate. This figure is mathematically equivalent to projecting earnings growth (with regular wage increases) in one step and then discounting it back to present value in a second step. However, when a single net discount rate is used to project the present value of a long future earnings stream, the simplicity of the approach can lead to misleading calculations because the relationship between interest rates and wage growth does not necessarily remain constant over time.

The ultimate impact of differences in discount rate assumptions on overall damages, however, will depend on how long economic losses are expected to extend into the future. If the damage period is short, for example, because the plaintiff was only expected to work at the former employer for a few years or earnings are expected to recover relatively quickly, then differences in interest rate assumptions become much less important to the bottom line calculations.

### Closing Thoughts

While the same general framework for calculating economic damages can be applied to wrongful termination and other similar cases, each case has its own set of unique facts and each plaintiff has his own story. There is no “one size fits all” approach or formula. Thus, the underlying assumptions and methodology should be tailored to the specific facts and nuances of the case at hand.



## Appendix

### **Economic Expert Document Checklist -- Calculation of Lost Earnings and Benefits**

Documents typically requested include the following (if available or applicable to the case):

#### General Information/Documents

- Complaint for damages
- Name, birth date, race and gender of plaintiff
- Names and birth dates for dependent children
- Resume of plaintiff
- W-2 and 1099 Misc. income statements for past 5-7 years
- Deposition testimony of the plaintiff
- Disability benefit documents
- Interrogatory responses related to job search and employment activity post-termination and claims for damages
- Job search activity logs (e.g., dates of application, interview and/or follow up with potential employers)
- Letters, emails and other correspondences related to job search efforts and job applications

#### For Previous (Defendant) Employer and for Employers Since Termination

- Name of employer and dates of employment (start, end and LOA dates)
- Job description of position or positions held
- Application for employment
- Offer letter of employment
- Employee handbook
- COBRA offer letter
- Health plan coverage and employee contribution, if any
- Retirement plan overview and statements, if any
- 401K plan overview and contribution history, if any
- Bonus plan overview and award history, amounts and dates, if any
- Stock option plan overview, statement of awards, grant/exercise dates and amounts, if any
- Pay statements (stubs)
- Earnings history including job title, base pay, merit increases, bonus payments, dates awarded and dates of job/pay changes (past 5 years for defendant, all records for post-termination employment)