Advocate's Edge

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Wage wars

The battle over lost earnings

Lost earnings claims arise in a variety of contexts, from employment discrimination and wrongful termination to personal injury and wrongful death. Whichever side of a suit you're on, understanding the underpinnings of these damages will help you prepare for the common issues they raise.

Laying the foundation: Base earnings

The basic building block for calculating lost earnings damages is "base earnings" — the assumed earnings rate for a specific year from which lost earnings are extrapolated. Depending on the circumstances, base earnings might be actual earnings in the year before the injury, projected earnings for the year of the injury, or the expected earnings rate for a future year.

To determine base earnings, financial experts gather data from a variety of sources, including employer records, employee pay stubs, income tax records, Social Security records, census information, union contracts and earnings of similarly employed individuals.

If the plaintiff has worked for the same employer for many years, calculating base earnings is relatively straightforward. But the computation becomes more complicated if the plaintiff's earnings record lacks steady annual increases. Irregular earnings call for an expert to consider additional information to help interpret the data. Information about a plaintiff's seniority, past health or productivity declines, for example, can shed light on otherwise statistically questionable earnings data.

Once the base year is established, experts should extrapolate lost earnings carefully to avoid miscalculations. Seasonal variations and accrued vacation and sick pay can skew base earnings. Base earnings also should be adjusted to account for one-time, nonrecurring payments — such as a special bonus — or permanent changes in the employer's

circumstances — such as a transition from the unstable startup phase to a growth or maturity stage.

Building a case: Common issues

Beyond the base earnings question, financial experts can address several recurring issues related to lost earnings.

What, for example, should be included in lost earnings and how should each component be measured? Wages and salary rarely precipitate much dispute, but variable components of compensation may be subject to disagreement. Experts can help frame the proper measurement of commissions, overtime and performance bonuses for the trier of fact.

Another challenge for financial experts is to place a monetary value on fringe benefits. Benefits that aren't paid in cash might be valued at the employer's cost or at the value to the employee. With vacation and sick pay, defendants want to avoid double recovery if the benefits are included in cash earnings.

As with most damages, the plaintiff is charged with mitigating the loss. A defendant might assert that the plaintiff took an unreasonable amount of time to locate a new job or accepted a position that doesn't

An alternative to lost earnings

In lieu of seeking lost earnings, a plaintiff may pursue damages for loss of earning capacity. Some plaintiffs find this approach preferable because the requirements aren't as strict. The plaintiff need not even have been employed at the time of injury because the damages aren't based on actual earnings.

Loss of earning capacity estimates a plaintiff's lost ability to work in appropriate occupations now and into the future. A plaintiff who earns the same wages after his injury may nonetheless present a lost capacity claim for a likely diminution in earnings at some future point or an increase in the effort required to maintain earnings at the same level.

The plaintiff also can select from a wider range of occupations upon which to base damages. If the plaintiff was qualified for several occupations before the injury, he or she can claim compensation for elimination of choice after the injury, regardless of whether the plaintiff ultimately would have chosen a now-eliminated occupation.

A plaintiff also might be entitled to compensation for an occupation for which he or she could have become qualified but for the injury. In that case, the plaintiff must show some likelihood he or she would have become so qualified; mere aspiration is insufficient. For example, a college English professor may not seek lost capacity damages based on a secret dream to become an astronaut. Lost capacity damages should be based on the occupation for which the plaintiff is now or is likely to become qualified that offers the highest compensation.

In addition to compensation and fringe benefits, the amount of lost capacity damages should reflect the plaintiff's age, health, education and experience; estimated recovery time and work-life; probable career path; and, in some cases, income taxes. The collateral source rule and similar principles also come into play.

pay enough. A plaintiff might reasonably have taken a lower-paying job with the expectation of future pay raises, but, if he or she accepted the job for noneconomic reasons, the defendant might argue that the plaintiff's damages should be calculated as if the plaintiff had accepted the highest-paying job alternative.

What if the plaintiff starts his or her own business or returns to school to train for another job? How should the plaintiff's activities during this time be valued? Should the defendant receive an offset for the plaintiff's investment in a new business or in tuition and other educational expenses? If the tuition or new business investment can reasonably be expected to produce earnings that reduce the defendant's liability, it's probably reasonable to require the defendant to pay full but-for earnings during the school or startup period.

Career path projections present another hurdle. The parties are unlikely to agree on the plaintiff's future compensation increases. Further arguments can arise over the plaintiff's probable retirement and mortality. With the availability of specialized data that accounts for factors like smoking or motorcycle riding, even the selection of work-life expectancy tables and statistics becomes fodder for dispute.

Finally, financial experts should discount future lost earnings to present value, using a real or nominal interest rate. The appropriate rate is usually open to debate. If, for instance, the parties agree to use a rate that the plaintiff could earn by investing the money, which type of investment is appropriate? Something safe like a low-yield money market account or a vehicle with more risk but greater upside potential? And should the discount rate be applied before or after taxes?

A team approach

With so many issues involved in computing lost earnings, getting financial experts into the game early can help ensure the best outcome. Experts can provide guidance in requesting critical information and in developing targeted arguments to support or challenge lost earnings claims. You, in turn, should insist that both your and the opposing experts explain their data sources and the assumptions they rely on in making their earnings estimates. ✧

Going to market

An alternative to the income approach to business valuation

Valuators use a variety of methods to value a business, including income, asset-based and market approaches, or some combination of these approaches. The income approach is used most often for closely held businesses, but the market approach might not get the credit it deserves.

Income vs. market

Under the income approach, a valuator projects a business's future income (based on earnings, cash flow or some other measure of economic benefits) and discounts it to present value. The result, in theory, is the amount a hypothetical buyer would pay a hypothetical seller for the business.

The market approach looks at actual transactions, preferably at arm's length. The valuator considers comparable businesses or transactions and develops multipliers based on the similarities and differences between the comparable and subject companies. In some cases, a value reached under the market approach may be more accurate because it depends on actual prices agreed to by real buyers and sellers.

A market-approach valuation is only as good as its underlying data, so valuators sometimes hesitate to rely on it if insufficient data is available or if available data isn't sufficiently comparable. In the age of the Internet, though, the number of data sources continues to grow. Valuators easily can glean information from online databases of private and public transaction data, listings in trade publications or by brokers, public trades and merger and acquisition activity.

While comparables from the same industry as the subject business are preferred, they're not always required. In some cases, it may be possible to rely on comparables from other industries — as long as the companies have similar debt, net fixed assets, revenues, profits and markets — with appropriate adjustments for industry differences.

The mechanics of the market approach

Valuators can employ several different market methods when valuing a closely held business:

Guideline company method. This method depends on public company data. The SEC provides a wealth of such information. The breadth of information means a valuator has many possible comparison points, and the transactions are usually at arm's length, making them particularly suitable for valuation purposes. On the other hand, it takes a lot of time and money to comb through, analyze and adjust the mounds of SEC data, and share prices for public companies are more volatile than for private companies.

Public companies' revenues, markets and capitalizations differ dramatically from those of a smaller business, but valuators can account for those and other disparities with discounts and premiums. A premium may be justified, for example, if the subject business

or interest is owned by a single person who exerts much control over the company, unlike the typical shareholder in a public company. Some experts counter that a combination of minority interests in a public company can indeed apply pressure to management, making a premium unnecessary. They also may argue that, because shares in a public company are far more liquid, a discount should be applied.

Mergers and acquisitions (M&A) method. The M&A method may suffer in comparison to the guideline company method because less data is available, and it can be difficult to verify or even obtain critical information. But M&A transactions are useful because they usually involve 100% interests and companies that are more similar to closely held businesses. The valuator will probably need to apply a discount for lack of control — and possibly for lack of marketability — and additional adjustments may be necessary, depending on whether a transaction involves a stock or asset purchase.

Direct market method. The valuator scrutinizes transactions involving closely held businesses. These businesses generally boast greater price/value stability than public companies, but valuators may have trouble verifying transaction details (especially if data is not reported consistently) and some industries see few transactions. A valuator is likely to pay close attention to differences in liquidity, profits, risk, sales time and terms.

Prior transactions. Valuators also can look at a subject company's own transactions, such as buy-sell agreements, buy-ins, buyouts, mergers and acquisitions, and offers for sale or purchase.

It's worth considering

The market approach can prove tricky with smaller businesses, but it shouldn't be ruled out. Even if a valuator relies on the income approach, the market approach can help support his or her conclusions. ✧

Tax Court ignores experts, applies 35% discount to FLP interests

In *Estate of Kelley*, the Tax Court applied a combined 35% discount for lack of marketability and control to a decedent's 94% interest in a family limited partnership (FLP) holding only cash and certificates of deposit. In reaching this conclusion, the court essentially disregarded both sides' experts.

Getting to the Tax Court

Mr. Kelley formed an FLP with his daughter and son-in-law. Each contributed cash or CDs in exchange for limited partnership interests. A limited liability company (LLC) owned by the three held a 1% general partner interest in the FLP.

Kelley died shortly after the FLP was formed, and his estate claimed a combined 53% discount on his interest. The IRS argued for a discount of only 25.2%.

Quantifying lack of control

To determine the lack of control discount, both experts referred to general equity closed-end mutual funds, in which shareholders retain no control over fund assets. The experts divided the comparable closed-end funds into quartiles. The first quartile represented funds in high demand and trading at

premiums or at least low discounts; the fourth quartile represented funds in low demand, with higher discounts.

The estate's expert determined that the Kelley FLP was most comparable to fourth-quartile funds. He made additional adjustments based on several factors and restrictions inherent in the FLP, as well as other partnership studies, and proposed a 25% discount for lack of control. The IRS expert considered the funds in all four quartiles to calculate the discount at an arithmetic mean of 12%.

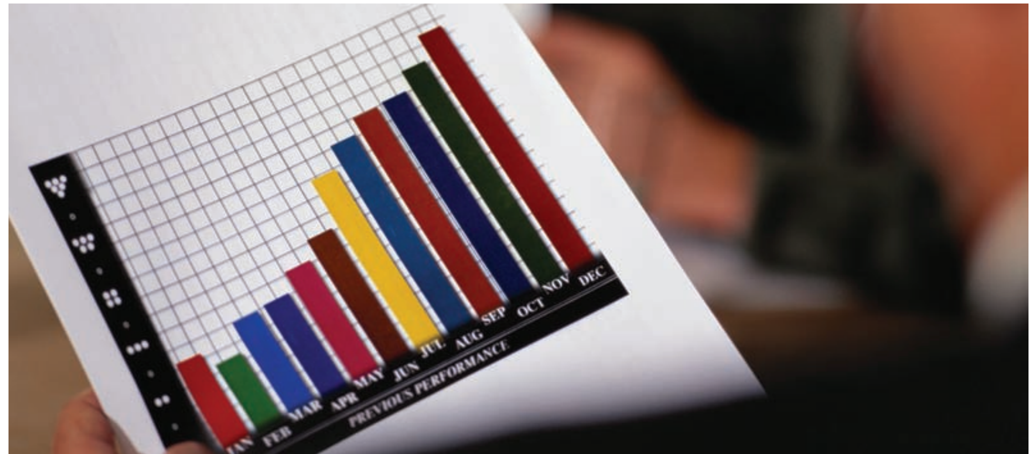
The Tax Court rejected the exclusive use of fourth-quartile funds, finding that the fourth quartile alone didn't consider a sufficient number of comparables to reach a conclusion. It also rejected the estate expert's additional adjustments because the partnership studies used contained an element of discount attributable to lack of marketability, rather than just control. Although the court found neither expert "particularly persuasive," it agreed that the proper method was to take the arithmetic mean of all the closed-end funds. It applied the 12% discount because the estate expert failed to prove that a higher rate was appropriate.

Quantifying lack of marketability

In determining the discount for lack of marketability, the court concluded that the private placement approach was suitable where the interest to be valued is part of an investment company. This approach "attempts to isolate the effect that impaired marketability has on the discount determined under the restricted stock approach." The restricted stock approach compares private market prices of restricted shares in public companies with the public-market prices for unrestricted shares in the same company.

The estate expert relied on restricted stock studies, while also outlining numerous barriers to the marketability of the decedent's interest in the FLP. He proffered a discount of 38%. The IRS expert used the private placement approach and assigned a 15% discount based on a study by Dr. Mukesh Bajaj and the low risk of the FLP's portfolio.

The Tax Court criticized the estate expert for using studies that concentrated on operating companies rather than investment companies. It also dismissed the IRS expert's opinion: The court agreed that the Bajaj study was an appropriate tool for determining the discount but found that the IRS expert did not apply it correctly. "As we find [the experts' testimony] only minimally helpful, we use our own analysis and judgment," the court said.



The court cited a previous case where it relied on the Bajaj study, which divided the private placements into three groups according to the level of discounts. The court placed the Kelley FLP in the middle group, with a discount rate of 20%. It then adjusted the discount upward by 3% because the FLP was closely held, relatively small and unknown, had no present market for its interests or real prospect of going public, and held a right of first refusal to purchase interests.

A key piece of the puzzle

Kelley demonstrates once again the importance of selecting the right financial expert to support your case. In *Kelley*, the estate found itself on the hook for taxes on about $266,500 in value in excess of what it originally claimed. When a court resorts to its own judgment, it can prove costly. ✧

When assessing damages, interest merits a closer look

Interest on damage awards is often an afterthought, but you need to think about interest issues early on, particularly in federal courts and states that allow generous interest. With some states authorizing rates as high as 12%, interest awards can give a sizable boost to a judgment's bottom line.

General interest

Depending on the jurisdiction, a court can award both prejudgment interest and postjudgment interest. Postjudgment interest applies to all monetary awards as an incentive for prompt payment; prejudgment interest is triggered only in certain circumstances to compensate a plaintiff for economic losses.

Under common law, prejudgment interest is allowed only for liquidated damages. The definitions of "liquidated" and "unliquidated" damages vary by jurisdiction, but liquidated damages generally can be calculated before judgment, while unliquidated damages are based on the factfinder's discretion and typically are derived from nonpecuniary losses. Many states allow prejudgment interest on unliquidated damages beginning on the date of a good-faith settlement offer or specific court finding.

Jurisdiction matters

A case's venue and applicable law are pivotal in determining the impact of interest on an overall award.

If a case is brought under a federal statute, the statute's language controls prejudgment interest. If it specifically provides for damages, but excludes prejudgment interest, a plaintiff can't recover such interest. If the statute doesn't address prejudgment interest, the court has discretion as to whether to award interest and, if so, under which method and rate. For example, most state and federal statutes that address interest call for simple interest. But when an interest award is discretionary, it may be reasonable to argue that compound interest is appropriate under certain circumstances.

States differ on the allowance of — and rate for — prejudgment interest, and a state's law on the matter can significantly increase a defendant's financial liability. For example, a state may set an interest rate at 12% in most cases and place cases with the potential for substantial verdicts on a three-year track, raising the possibility of adding 36% interest to a judgment.

The statutes in some states set interest rates using variable market rates. The applicable market rate might come from the Federal Reserve, the Treasury or other sources. A state's statute also might tack on an additional 1% to 3% to the market rate. Of course, some states operate under common law and deny prejudgment interest on tort actions.

Postjudgment interest is more widely accepted across jurisdictions. As with prejudgment interest, some states refer to market rates; others set a flat rate. Note that these rates assume the lawsuit doesn't involve a contract that established the applicable interest rates. Also, interest rates tend to be lower when the defendant is a governmental body.

Catching your interest

If you discuss interest issues with your financial expert as early as possible, especially in federal cases, the expert can help you develop strategies for maximizing the interest award and can alert you to potential evidentiary hurdles. ✧

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