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# What is an Appropriate Discount Rate in a Lost Earning Capacity Assessment, and Why is it Important?

by Alex L. Constable, ASA

When representing a plaintiff who because of his or her injuries cannot work, one recoverable item of damages is that individual's Lost Earning Capacity.

## Earning Capacity

Ohio Courts have defined lost earning capacity as follows. In *Hanna v. Stoll*, 112 Ohio St. 344, 353, 147 N.E. 339, 341 (1925), the Court indicated,

> The measure of damages for impairment of earning capacity is the difference between the amount which the plaintiff was capable of earning before his injury and that which he is capable of earning thereafter.

Earning capacity is a measure of a person's ability and/or power to earn as opposed to actual lost wages. The fact that the plaintiff may have been unemployed at the time of the injury is not fatal to recovering for a loss of earning capacity. In *Eastman v. Stanley Works*, 180 Ohio App.3d 844, 2009-Ohio-634, ¶ 59, the court recognized that earning capacity "*is not necessarily dependent upon what is actually earned before or after the injury.*" In Ohio, this category of damages is still not subject to any artificial limitation.

Your economic expert has many important considerations for a damage analysis in a Loss of Earning Capacity Report. These include years in the work force, appropriate levels of income and fringe benefits and how they change over time, growth rates (if any) of income and fringe benefits, and finally, the interest, or Discount Rate used to bring future dollars back to Present Value. Selection of the appropriate Discount Rate is a critical part of the Present Value analysis.

## Discount Rate and Present Value

In an earnings case, a Discount Rate is a rate of return paid in the future as interest on today's invested capital. The terms Discount and Interest are interchangeable. In essence, one accepts a reduced amount to receive cash today (i.e. discount) in exchange for future interest and a future stream of cash flows, or lost future earnings.

Present Value is the measure of the time-value of money. It gives the current value of a future sum of money (or future flow of monies) based on a specified Discount (or Interest) Rate. As such it represents the lump-sum dollar amount given today in exchange for future monies.

According to the Ohio Jury Instructions:

> 1. PRESENT PECUNIARY VALUE. In the event you find for the plaintiff, the measure of any future damage is the present (loss in dollars) (pecuniary loss) which the (plaintiff) (heirs) with reasonable certainty will sustain in the future, and which is

capable of measurement by the present value of money. (You may not speculate upon any change in the value of the dollar). OJI-CV 315.45 §1.

## Discount Rate Selection

Mathematically, the total Present Value dollars and the Discount Rate are inversely related; the higher the discount rate, the lower the total Present Value, and vice versa. For example, consider the following alternatives:

1) If one selects 9% as the Discount Rate for a future stream of annual payments of $25,000 (e.g. Total Annual Earnings) for the next 15 years starting today, the corresponding Present Value is $219,654. A 9% Discount Rate corresponds to a long-term, riskier, average stock market investment return.

2) If one selects 1.74% as the Discount Rate in the same scenario, the corresponding Present Value is $333,296. The 1.74% is the 2013 average market yield on U.S. Treasury securities corresponding to the term in this illustration. U.S. Treasury Securities are the benchmark interest rate for an investment return with no risk of the loss of principal, and are therefore viewed as being "risk-free."

So why the difference in Discount Rates? Higher Discount Rates are commensurate with higher risk. Risks may include inflationary erosion in the value of future monies, high volatility, and/or outright loss of invested capital. Lower Discount Rates preserve and protect the capital invested. Examples, building from low risk to high risk, are U.S. Treasury Securities (bills and bonds), State and local government bonds, corporate bonds, and then large and small company stocks.

An important consideration which is reflected in the above example is that if one were to accept a risk-adjusted Discount Rate in the damage analysis for a Lost Earning Capacity report (e.g. 9%), there would be adverse risk sharing among the parties. That is the plaintiff would be assigned all of the inherent risk that accompanies use of a higher Discount Rate while the defendant receives all of the benefit. The monetary burden of the shifted risk is the differential Present Value between use of the two Discount Rates (i.e., $333,269 less $219,654, or $113,615).

This economic Discount Rate selection is illustrated in *Jones & Laughlin Corp. v. Pfeifer*, 462 U.S. 523, 537, 103 S.Ct. 2541 (1983), where Justice Stevens observed as follows:

> The discount rate should be based on the rate of interest that would be earned on the best and safest investments. Once it is assumed that the injured worker would definitely have worked for a specific term of years, he is entitled to a risk-free stream of future income to replace his lost wages; therefore, the discount rate should not reflect the market's premium for investors who are willing to accept some risk of default.

## When do you need an Expert?

The spectrum of subjects as to which an economic damages expert may be required is broad and unique to each case. A typical case for my practice may be a Loss of Earnings opinion in a wrongful termination, injury, or death matter. In Business Litigation, I may be asked to speak to commercial damages such as a Loss of Profits from the violation of a non-compete, profit disgorgement, or a Reasonable Royalty Assessment. Other economic experts may be used to provide analyses in areas such as antitrust and competition policy, merger reviews, class certification, statistics, and survey/sampling design. Additionally, forensic accountants and valuation experts may opine on business values, reductions thereto, business interruption claims, and fraudulent activities.

In any economic damages case, consider the credentials, experience, and reputation of your expert. These are among your important considerations when protecting your client's legal rights. ■