Treatment of Benefits in Lost Earnings Calculations

Damages for lost earnings are sought in a variety of cases, ranging from wrongful discharge to wrongful death. Though sometimes overlooked initially, pension and other fringe benefits can have a substantial impact on the total lost earnings figure.

Pension Benefits

Pension benefits differ significantly from salary in that they typically extend beyond the claimant's expected work life. The proper amount of compensation for lost benefits depends on the type of pension plan involved.

Defined contribution plans present a more straightforward calculation for experts. Employer contributions are usually regarded as a portion of lost earnings in the years the contributions would have been made, thus, rather than projecting the post-retirement benefits to be paid, the expert adds the total "but-for" employer contributions to the "but-for" earnings.

Calculation under defined benefit plans can be trickier and may require projection of the actual benefit stream following retirement. Factors to consider in the calculation include the years of service, salary levels, retirement date, and life expectancy.

Although not supported by actuarial math, the "expected life approach" to life expectancy, which uses an average life expectancy to project the full benefits up to the estimated time of death, is often used. The alternative approach, known as the probabilistic method, multiplies the annual pension benefit by the probability that the plaintiff will survive from the current date until each future age up to the theoretical maximum age, and totals the products.

The two approaches to defined benefit plans rarely produce the same results, but the disparities generally aren't very significant. More substantial differences in the results will be noted when higher interest rates are applied.

Other Fringe Benefits

When calculating damages for other fringe benefits, the benefits received before the alleged wrong must be compared to those received after, possibly taking into account the replacement cost of the lost benefits (e.g., individual insurance rates may be higher than those paid under a group plan).

It's important to distinguish between those benefits that depend on the recipient's level of income and those that depend merely on being employed. Experts should also closely examine those benefits that both employer and employee contribute to — the employee's contribution would come out of his or her lost wages, meaning the employee would be doubly compensated if damages were paid for the contribution in addition to lost wages.

The Big Picture

Though common in numerous types of litigation, lost earnings calculations are often more complicated than they initially seem. Attorneys confronted with such damages are advised to consult with a qualified professional to ensure that no facet of the calculation is overlooked. ❖

Could your client fall for a trust scam?

In its most recent list of the so-called “dirty dozen” tax scams, the IRS noted that unscrupulous promoters are increasingly urging taxpayers to transfer assets into trusts. These promoters promise a range of tax benefits, including the reduction of taxable income and deductions for personal expenses paid by the trust.

The IRS warns that such abusive trust arrangements won’t produce the advertised benefits and may subject taxpayers to civil and criminal penalties.

Know the red flags

The IRS defines fraudulent trusts as those that hide true ownership of assets and income or that disguise the substance of financial transactions. Taxpayers who want to avoid getting snared by a scam artist should question trusts that feature the following:

- The reduction or elimination of income tax and self-employment tax,
- Deductions for personal expenses paid by the trust,
- Depreciation deductions on personal residences and furnishings,
- High fees for trust packages, to be offset by tax benefits,
- The use of back-dated documents,
- Unjustified replacement of the trustee,
- Lack of an independent trustee,

- The use of P.O. boxes for trust addresses, and

- The use of terms such as "pure," "constitutional" or "sovereign" trust or "unincorporated business organization."

Don't risk it

Trusts established for legitimate estate planning purposes remain valuable tools. But those intended to hide taxable income can prove costly.

Taxpayers will be held responsible for their own actions if they participate in fraudulent tax schemes. Civil convictions can bring a fraud penalty of up to 75% of unpaid taxes attributable to fraud, plus the taxes owed. Criminal convictions can result in fines as high as $250,000 and five years in prison for each offense.

The IRS notes that trusted tax professionals can help your clients avoid falling into trust traps.

Benchmarking can determine reasonable compensation

For years, financial experts and human resources professionals have used benchmarking to set or evaluate compensation levels. As executive compensation receives increasing scrutiny, benchmarking is positioned to play an expanding role in several areas.

The focus on compensation

Executive compensation can come under the microscope for a variety of reasons. Owners and employees of C corporations, for example, sometimes take greater compensation in lieu of dividends because a corporation must pay taxes on dividends, while compensation can be deducted. The IRS, however, only allows deductions for "reasonable compensation."

If the IRS claims that an executive's high compensation actually constitutes disguised dividends, benchmarking can help the executive show the compensation is indeed reasonable. In fact, the courts have developed a list of factors to consider on the issue of reasonable compensation, and many look at comparisons with executives of similar businesses.

The IRS isn't the only party that might be interested in compensation levels. Recent coverage of corporate scandals has raised skepticism among the public, employees, regulators and investors about executive compensation

packages. A 2003 Harris Poll found that 87% of the respondents believe that executives “had gotten rich at the expense of ordinary workers.”

Eighty-five percent of those respondents reported that they believed top executives receive more than they deserve, and 66% expressed their belief that workplace rewards are distributed less fairly than they were five years earlier. Benchmarking studies can assuage such suspicions.

The Pereira case

A federal district court opinion issued last year illustrates the importance of a properly conducted benchmarking study. Pereira v. Cogan, 294 B.R. 449 (S.D.N.Y. 2003), involved Trace International Holdings, a private holding company with majority ownership in two public companies. Marshall S. Cogan functioned as founder, CEO, controlling shareholder and chair of the company’s board of directors.

Trace declared bankruptcy in 1999, and Pereira, the trustee appointed to oversee the company’s liquidation, brought suit against Cogan and several of Trace’s officers and directors. Pereira alleged the individuals breached their fiduciary duties to the company’s creditors in regard to Cogan’s numerous acts of self-dealing, including his excessive compensation.

In addressing the issue of excessive compensation, the court recognized the value of benchmarking but cautioned that the members of the comparator group, whose compensation packages are used as a barometer, must be truly comparable to the position under evaluation. According to the court’s opinion, “That means that the comparator group should be composed of executives performing similar tasks at companies in similar industries and of similar size and revenue as the company whose executive position is being benchmarked.”

The parties’ experts performed benchmarking studies but used different comparator groups — heads of operating companies versus heads of venture capital firms. The court rejected both experts’ conclusions, finding that Cogan’s position with Trace was a hybrid of the two comparator groups.

Rarely should compensation data be taken at face value. As the Pereira court noted, financial experts may need to adjust the data to account for geographic area, industry, organization size, qualifications and timing.

Further, some studies fail to distinguish between low-performing and high-performing companies, an extremely relevant factor in determining reasonable compensation. Data also should reflect the value of the perks associated with both the position at issue and comparator positions.

Gathering the data

Interested parties can obtain compensation data more easily than ever these days. Hundreds of surveys can be located on the Internet, and the Securities and Exchange Commission provides data on the companies it oversees. (For more information about compensation-related surveys, see "Additional sources" below.)

The National Survey Center in Washington, D.C., serves as another excellent source. In some cases, though, as in Pereira, customized data may prove necessary.

Sidebar: Additional sources

Numerous Web sites offer compensation data that may assist in your benchmarking efforts. Among them are:

- www.sec.gov
- www.bls.gov/ncs/home.htm (U.S. Department of Labor, Bureau of Labor Statistics)
- www.psrinc.com/Salary.htm (Janco Associates, Inc.)
- www.bfmag.com/resources/salary/ (Business Finance)
- www.infoworld.com/reports/SRcomp.html (InfoWorld)
- www.loma.org/compexec.asp (LOMA) ❖