

Torts-Damages-Consideration of Inflation in Calculating Lost Future Earnings

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RECENT DEVELOPMENT

Torts—Damages—CONSIDERATION OF INFLATION IN CALCULATING LOST FUTURE EARNINGS

Feldman v. Allegheny Airlines, Inc.,
524 F.2d 384 (2d Cir. 1975)

An important element of damages in wrongful death or serious personal injury actions is loss of future earning capacity.¹ The trier of fact, in calculating the amount of wages which the decedent or injured person would have earned in his working lifetime, faces a task fraught with speculation.² In calculating such damages, courts have long recognized the investment potential of a sum of money awarded *now* for future damages.³ Consequently, they have required the reduction of lump-sum awards for lost future earnings to their present value by an appropriate discount factor.⁴ Traditionally, however, triers of fact have ignored three additional factors that affect the true value of a plaintiff's award—income taxation,⁵ attorneys' fees,⁶ and inflation.⁷

Since damage awards are not taxable,⁸ lump-sum awards for lost future earnings overcompensate plaintiffs by an amount equal to the income taxes that would have been paid on those earnings. However, payments of attorneys' fees, usually out of the damage proceeds, decrease the amount of actual awards going to plaintiffs.

¹ See J. STEIN, DAMAGES AND RECOVERY § 6, at 7 (1972).

² See 2 F. HARPER & F. JAMES, THE LAW OF TORTS § 25.8, at 1316-18 (1956). The jury should consider such factors as the plaintiff's health, habits, and skill, as well as labor market conditions and chances of advancement or lay-off. *Id.* at 1317.

³ See notes 11-12 and accompanying text *infra*.

⁴ See note 11 and accompanying text *infra*.

⁵ See 2 F. HARPER & F. JAMES, *supra* note 2, § 25.12; J. STEIN, *supra* note 1, § 6, at 8. Harper and James argue that compensatory principles permit the plaintiff to recover only his actual loss and, therefore, courts should deduct income taxes from lost future earnings because such damage recoveries are tax-exempt. I.R.C. § 104(a)(2). Although this requires courts to speculate about future tax rates, Harper and James assert that such predictions are inherent in a system of single lump-sum recoveries. They also note the danger that tax-conscious juries, ignorant of the exemption, will adjust the award upward to take into account the imagined tax. 2 F. HARPER & F. JAMES *supra* note 2, § 25.12.

⁶ See 1 S. SPEISER, ATTORNEYS' FEES § 12.3, at 463-64 (1973).

⁷ See 2 F. HARPER & F. JAMES, *supra* note 2, § 25.11.

⁸ I.R.C. § 104(a)(2). For a discussion of the policy considerations in this field, see Yorio, *Policy Considerations in the Taxation of Damages*, 62 CORNELL L. REV. 701 (1977).

In addition, failure to consider the effect of inflation on future wages undercompensates plaintiffs.⁹ At least two factors—income tax exemption and inflation—should be considered by the trier of fact in determining damage awards.¹⁰

I

EFFECT OF INFLATION ON LOST
FUTURE EARNINGS

The present-value rule states that all damage awards for lost future earnings must be discounted to reflect their investment potential.¹¹ For example: Suppose a forty-five year-old man is permanently and totally disabled in an accident caused by the negligence of another party. In a suit for damages, the plaintiff includes a claim for loss of future earnings; the court finds that the man had an earning potential of \$10,000 per year. Prior to the accident the plaintiff's life expectancy and job would have permitted him to work for twenty more years—until age sixty-five. It would first appear that the plaintiff's damages for lost future earnings should equal \$200,000: \$10,000 per year multiplied by twenty years of remaining worklife. However, the investment potential of \$200,000, if actualized, would cause overcompensation of the plaintiff because there would still be funds left over at the end of twenty years, assuming annual withdrawals of \$10,000.¹² To pre-

⁹ See notes 15-19 and accompanying text *infra*.

¹⁰ This Note does not argue that plaintiffs should recover attorneys' fees as part of damages because this would constitute a radical departure from past practice. Under the traditional American approach courts do not consider attorneys' fees. 1 S. SPEISER, *supra* note 6, § 12.3, at 463-64. Speiser states: "It has been a consistent rule throughout the United States that a litigant has no inherent right to have his attorneys' fees paid by his opponent or opponents. Such an item is not recoverable in the ordinary case as damages . . ." *Id.*

For a classic example of the judicial justification for ignoring the effects of taxes, inflation, and attorneys' fees on damage awards, see *McWeeney v. New York, N.H. & H.R.R.*, 282 F.2d 34, 38 (2d Cir.), *cert. denied*, 364 U.S. 870 (1960) (tax benefits to plaintiffs are roughly counterbalanced by payments of attorneys' fees and probable losses from future inflation).

¹¹ *Chesapeake & Ohio Ry. v. Kelly*, 241 U.S. 485 (1916). In this case, the Supreme Court firmly established the present-value rule when future damages are involved. It reversed the Kentucky Court of Appeals' affirmance of the trial court's instruction to the jury to compute the lump sum of lost future earnings based on probable gross income without any adjustments. *Id.* at 488, *reversing Chesapeake & Ohio Ry. v. Kelly's Adm'x*, 160 Ky. 296, 303, 169 S.W. 736, 739-40 (1914).

¹² For example, if \$200,000 were deposited in a savings account paying 5% annual interest, the first year's interest would be \$10,000. This means that the plaintiff would be overcompensated by \$10,000 at the end of just the first year.

vent unjust enrichment, the award must be reduced to a lesser amount which, if invested at a given rate of interest, would provide a future stream of payments equaling \$10,000 per year, and would result in a zero balance at the end of the twenty-year period.

Persistent inflation prompts reevaluation of the automatic application of the present-value rule. The rule was established in 1916—a time of relative price stability¹³—but, with the exception of the Depression of the 1930's, the Consumer Price Index, a leading indicator of inflation, has risen steadily since that time.¹⁴ Returning to the forty-five year-old plaintiff, consider the \$200,000 lump sum amount of lost future earnings reduced to present value using a discount rate of four percent.¹⁵ Its present value would be roughly \$136,000,¹⁶ which, if invested at four percent interest, would enable the plaintiff to withdraw \$10,000 annually for twenty years. However, with an annual inflation rate of two percent,¹⁷ the plaintiff would have a "real yield" of only two percent per year on his award.¹⁸ In order to give the plaintiff the equivalent of \$10,000 purchasing power each year in present dollars, it would be necessary to award him approximately \$163,500, or \$27,500 more than under the traditional present-value calculation.¹⁹

¹³ With the exception of an inflationary period coinciding with the Civil War, the level of prices from 1826 to 1916 (the year of the *Kelly* decision (see note 11 *supra*)) was very steady. Using 1967=100, the Consumer Price Index (CPI) was 34 in 1826 and 32.7 in 1916. Excepting the period 1863-1873, the price level never rose above 34 nor fell below 25. BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, HANDBOOK OF LABOR STATISTICS 1975, at 313 (Table 122) [hereinafter cited as HANDBOOK OF LABOR STATISTICS]. Against this backdrop of price stability, the Supreme Court decided that a damage award should be reduced to present value. *Chesapeake & Ohio Ry. v. Kelly*, 241 U.S. 485 (1916). Clearly the Court did not foresee future inflation when it said: "It is self-evident that a given sum of money in hand is worth more than the like sum of money payable in the future." *Id.* at 489. However, as inflation offsets the future earning power of money, the difference in value between a sum of money now and a like sum in the future will decrease as the inflation rate approaches the interest rate payable on the sum of money. See Henderson, *The Consideration of Increased Productivity and the Discounting of Future Earnings to Present Value*, 20 S.D. L. REV. 307, 309-10 (1975).

¹⁴ Using 1967=100, the CPI rose from 32.7 in 1916 to 125.3 in 1972. Over half of this increase has occurred since 1947, when the CPI was 66.9. HANDBOOK OF LABOR STATISTICS, *supra* note 13, at 313. The CPI was 133.1 in 1973, 147.7 in 1974, and 161.2 in 1975. BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, MONTHLY LABOR REVIEW, Jan. 1977, at 93 (Table 22).

¹⁵ Courts frequently use a discount rate of 4%. See 1 S. SPEISER, RECOVERY FOR WRONGFUL DEATH § 8.4, at 711 & n.33 (2d ed. 1975).

¹⁶ See *id.* at 717.

¹⁷ For the period 1947-1972 (avoiding the extreme inflationary pressures of 1973-1975), the average yearly decrease in the purchasing power of the dollar was 2.3%. HANDBOOK OF LABOR STATISTICS, *supra* note 13, at 313.

¹⁸ The "real yield" on a sum of money is simply the discount rate minus the inflation rate. See note 73 *infra*.

¹⁹ See 1 S. SPEISER, *supra* note 15, at 714.

The common argument against considering future inflation²⁰ in damage awards is that it leads to undue speculation on the part of the jury.²¹ For example, in *Sleeman v. Chesapeake & Ohio Railway Co.*,²² the Sixth Circuit refused to permit consideration of inflationary trends in determining damage awards because the validity of such a consideration was unresolved in extra-judicial forums.²³ The counter-argument is that jury determinations are largely conjectural and function only in terms of probability and not cer-

²⁰ This Note does not discuss the consideration of past and present inflation by appellate courts in deciding whether a jury verdict for damages is excessive. It is well-settled that such consideration is appropriate when an appellate court compares the size of a contested verdict to awards for comparable injuries in previous years. See Annot., 12 A.L.R.2d 611 (1950).

²¹ See *Johnson v. Penrod Drilling Co.*, 510 F.2d 234 (5th Cir.), cert. denied, 423 U.S. 839 (1975); *In re U.S. Steel Corp.*, 436 F.2d 1256 (6th Cir. 1970), cert. denied, 402 U.S. 987 (1971); *Williams v. United States*, 435 F.2d 804 (1st Cir. 1970); *Frankel v. United States*, 321 F. Supp. 1331 (E.D. Pa. 1970), aff'd sub nom. *Frankel v. Heym*, 466 F.2d 1226 (3d Cir. 1972); 2 F. HARPER & F. JAMES, *supra* note 2, § 25.11, at 1325-26:

[C]onfusion surrounds present damages for future loss. Future trends in the value of money are necessarily unknown and so always render such damages speculative in a way we cannot escape. If the estimates represent a straight-line projection of present living costs, they will be frustrated by fluctuations either way. If prophecy of change is heeded, frustration will follow if no change, or the opposite change, occurs. . . . For the most part the problem—which is inevitably present in every case of future loss—is not analyzed and the present value of money is assumed to be the proper basis.

²² 414 F.2d 305 (6th Cir. 1969).

²³ *Id.* at 308. In *Sleeman*, a personal injury action under the Federal Employers' Liability Act, 45 U.S.C. §§ 51-60 (1970) (F.E.L.A.), the Sixth Circuit rejected the district court's reasoning that inflationary trends would offset any present-value reduction. 414 F.2d at 307. The court of appeals found no evidentiary basis in the record for the district judge's decision and stated:

Nor do we encourage the trial courts of our circuit to explore such speculative influences on future damages as inflation and deflation.

Of course, the nation's economic history since the 1930's would appear to make the use of present wages as the standard for loss of future earnings somewhat unfair to plaintiffs. But as to the future, the inflation versus deflation debate rages inconclusively at the highest policy levels of our government, in national electoral campaigns, in learned economic journals and is exemplified in the daily gyrations of the stock markets. The debate seems unlikely to be resolved satisfactorily in one personal injury trial. And if testimonial resolution of this factor bearing on the future is attempted, the door is opened to similarly speculative and debatable offsets tending in other directions.

Id. at 308.

Although *Sleeman* remains a leading case on this issue and courts continue to find its reasoning persuasive (see, e.g., *Johnson v. Penrod Drilling Co.*, 510 F.2d 234, 240-41 (5th Cir.), cert. denied, 423 U.S. 839 (1975)), its vitality within the Sixth Circuit is in doubt. See *Bach v. Penn Cent. Transp. Co.*, 502 F.2d 1117, 1122 (6th Cir. 1974) (F.E.L.A. case; error for judge to instruct jury not to consider future inflationary trends); cf. *Willmore v. Hertz Corp.*, 437 F.2d 357 (6th Cir. 1971) (Michigan law; judge's instruction to jury to consider inflation not erroneous).

tainty.²⁴ In *United States v. English*,²⁵ the Ninth Circuit held that a trier of fact may consider inflation in computing a damage award.²⁶ The court noted that predictions about future incomes and expenses, especially of infants, are as speculative as inflation projections but are nonetheless made by courts.²⁷

Courts permitting consideration of the inflation factor have taken one of three approaches. The most extreme view permits juries to compensate for inflation without the benefit of expert testimony.²⁸ Thus, in *Bach v. Penn Central Transportation Co.*,²⁹ where there was no expert testimony, the Sixth Circuit found error in the lower court's charge to the jury not to consider future inflation as an element in computing lost future earnings.³⁰ The court emphasized an average juror's common experience with inflation, the necessity for proper compensation of the plaintiff, and the availability of a judge's power of remittitur³¹ in case of an outrageous verdict.³² Nevertheless, given the complexity of such determinations, judges and juries are ill-equipped to predict future inflation without the aid of expert testimony.³³

²⁴ See, e.g., *Plourd v. Southern Pac. Transp. Co.*, 266 Ore. 666, 679, 513 P.2d 1140, 1147 (1973) (permissible for expert witness to assume future increases in wage rates).

²⁵ 521 F.2d 63 (9th Cir. 1975) (wrongful death action under Federal Tort Claims Act).

²⁶ *Id.* at 75. The Ninth Circuit also held that the lower court had erred in failing to discount to present value the damage award for future earnings. *Id.* at 72.

²⁷ The Ninth Circuit said:

We would also feel impelled to [take into account future inflation] for policy considerations. . . . While predicting future inflationary trends, or extrapolating from present ones, may be speculative, so are most predictions courts make about future incomes, expenses (as, for example, in the case of the wrongful death of an infant). Since it is still more probable that there will in the future be changes in the purchasing power of the dollar, it is better to try as best we can to predict them rather than to ignore them altogether.

Id. at 75. The court also noted that the plaintiff must present "sound and substantial economic evidence" in order for the trier of fact to consider inflation. *Id.* at 75-76.

²⁸ See, e.g., *Riha v. Jasper Blackburn Corp.*, 516 F.2d 840, 845 (8th Cir. 1975) (dictum in applying Nebraska law).

²⁹ 502 F.2d 1117 (6th Cir. 1974) (F.E.L.A. wrongful death case).

³⁰ *Id.* at 1122.

³¹ The term "remittitur" refers to the court's action in diminishing the amount of a jury verdict in response to the defendant's motion for a new trial on the grounds of an excessive verdict. If the court finds grounds for granting the motion, "it may grant the plaintiff an election to remit a stated portion of the amount or submit to a new trial." 6A J. MOORE, MOORE'S FEDERAL PRACTICE ¶ 59.05 [3], at 59-47 to 59-48 (2d ed. 1974) (emphasis omitted) (footnotes omitted).

³² 502 F.2d at 1122.

³³ One commentator has suggested that using a special verdict could prevent jury confusion about inflation because it would leave the task of computing damages to the judge. The judge's award would be based on the jury's special findings concerning inflation and interest rates. Comment, *Damages for Loss of Future Income: Accounting for Inflation*, 6 U.S.F. L. REV. 311, 321-22 (1972). However, expert testimony must be the basis of a special ver-

Courts at the other extreme presume that the rate of inflation offsets the discount factor, thereby enabling the trier of fact to compute the loss of future earnings without any adjustments. The Alaska Supreme Court adopted such a rule in *Beaulieu v. Elliott*,³⁴ reasoning that otherwise a plaintiff would be forced to make other than "safe investments" in order to offset inflation.³⁵

The third approach uses expert testimony to assist in establishing proper discount and inflation rates.³⁶ The experts—usually economists³⁷—lay the foundation for their predictions by analyzing past economic trends. Because both the plaintiff and the defendant usually introduce expert testimony, it is up to the trier of fact to decide whom to believe. The jury is free to disregard all expert testimony, but, given the difficult nature of determining damages, a jury would probably consider some of the expert's testimony.

A recent Second Circuit case, following the third approach,

dict or its utility is largely lost. Absent expert testimony, the judge would be forced to use only his economic knowledge in charging the jury on the choice of a proper inflation rate.

³⁴ 434 P.2d 665, 671 (Alaska 1967).

³⁵ In *Beaulieu*, the court stated:

Since the plaintiff, through the defendant's fault and not his own, has been placed in the position of having no assurance [because of inflation] that his award of future earnings, reduced to present value, can be utilized so that he will ultimately realize his full earnings, we believe that justice will best be served by permitting the trier of fact to compute loss of future earnings without reduction to present value.

Id.

See Note, *Future Inflation and Damages*, 35 LA. L. REV. 883 (1975); cf. *Schnebly v. Baker*, 217 N.W.2d 708 (Iowa 1974). In *Schnebly*, a malpractice action where damages were mainly for future institutionalization of a retarded child, the discount factor was offset by inflation only after the trial court was satisfied that the two rates were roughly the same; the court permitted the introduction of expert testimony. *Id.* at 727-28.

³⁶ See *United States v. English*, 521 F.2d 63, 74-75 (9th Cir. 1975); *Schnebly v. Baker*, 217 N.W.2d 708, 727-28 (Iowa 1974); *Resner v. Northern Pac. Ry.*, 161 Mont. 177, 181-87, 505 P.2d 86, 88-91 (1973); *Tenore v. Nu Car Carriers, Inc.*, 67 N.J. 466, 475-83, 341 A.2d 613, 618-22 (1975); *Plourd v. Southern Pac. Transp. Co.*, 266 Ore. 666, 672-81, 513 P.2d 1140, 1144-48 (1973). In *Tenore*, the New Jersey Supreme Court ordered the trial court to allow expert testimony on projected inflation rates and discount factors, but prohibited introduction by the plaintiff of tables that provided exact figures of projected hypothetical earnings of the decedent adjusted for inflation. 67 N.J. at 481-82, 341 A.2d at 621-22. The court found such evidence improper for two reasons. First, the tables assumed that the decedent would not have suffered work interruptions for illness or due to lay-offs—a fact not within the expertise of plaintiff's expert witness, an economist. Second, the tables might have had an undue psychological impact on the jury resulting in uncritical acceptance. *Id.* at 482-83, 341 A.2d at 622. Cf. *Bach v. Penn Cent. Transp. Co.*, 502 F.2d 1117, 1122 (6th Cir. 1974) (expert testimony on exact income that decedent would have received inadmissible because too speculative).

³⁷ *But cf. Hoffman v. Sterling Drug, Inc.*, 485 F.2d 132, 143-44 (3d Cir. 1973) (expert testimony by economist acting in an actuarial capacity did not provide substantial basis for inflation projection).

approved a novel solution to the problem of adjusting damage awards for inflation. *Feldman v. Allegheny Airlines, Inc.*³⁸ held permissible an "inflation-adjusted" discount rate, which used an inflation factor to offset the anticipated rate of earnings from investment of the award.³⁹

II

CALCULATION OF AN "INFLATION-ADJUSTED" DISCOUNT RATE

On June 7, 1971, an Allegheny Airlines flight crashed in fog, killing Nancy Feldman, a passenger.⁴⁰ Her husband brought a wrongful death action in which Allegheny conceded liability. The parties submitted the issue of damages to the trial judge.⁴¹

District Judge Blumenfeld awarded damages of \$444,056, largely consisting of compensation for loss of future earning capacity.⁴² The lower court first computed a lump sum representing lost future earnings, without considering inflation.⁴³ Then,

³⁸ 524 F.2d 384 (2d Cir. 1975), *modifying* 382 F. Supp. 1271 (D. Conn. 1974).

³⁹ See text accompanying notes 48-55 *infra*. The Second Circuit in *Feldman* reversed the district court on two other points. First, the decedent's husband was entitled to recover "loss of earnings" for his wife's prospective child-bearing years only to the extent that she would have actually worked during those years. 524 F.2d at 388-89. The district court had valued the loss for this period at the salary level she would have reached in the year preceding the first child-bearing year. Second, the district court had underestimated the prospective living expenses that it was required to deduct under Connecticut law from the amount of future earnings. *Id.* at 389-90.

⁴⁰ Nancy Feldman was twenty-five years old at the time of her death and was looking for employment in Washington, D.C., where she and her husband intended to settle after he graduated from law school. *Id.* at 386.

⁴¹ *Id.*

⁴² *Id.* The lower court also awarded \$100,000 for destruction of the decedent's capacity to enjoy life's nonremunerative activities. 382 F. Supp. at 1299. This portion of the award was not altered on appeal. 524 F.2d at 390.

⁴³ 382 F. Supp. at 1287. Although the decedent did not have a job in the Washington, D.C. area at the time of her death, the district court utilized the federal government's "General Schedule" (GS) of civil service salaries in determining lost future earnings. The decedent's most recent job in Connecticut involved work similar to that done by the National League of Cities and United States Conference of Mayors (NLC/USCM) in Washington, D.C. The court used testimony from the personnel manager of NLC/USCM concerning the decedent's qualifications for a GS-12 position in their legislative research program as a basis for calculating lost future earnings. *Id.* at 1279. It assumed that the decedent would have progressed steadily up the GS scale, allowing an eight-year hiatus for raising children. *Id.* at 1286. According to the GS pay scale, the decedent would have been earning \$33,757 in the year 2011. *Id.* at 1287. The projection, therefore, included yearly merit pay increases, although the lost future earnings were first computed without adjustment for inflation. Had the court merely projected decedent's past earnings (\$10,000 in her last year), as is usually done in the absence of the type of evidence offered by the plaintiff, the total recovery would have been much less. The availability of a schedule of

in accordance with Connecticut law,⁴⁴ the judge subtracted a hypothetical income tax liability of twenty-five percent of gross income per year.⁴⁵ In determining the discount factor, the court first considered past yields on investments that would be risk-free were it not for inflation.⁴⁶ From this discount factor, Judge Blumenfeld subtracted the average inflation rate over the same period.⁴⁷ The resulting "inflation-adjusted" discount rate was used to calculate the present value of the lost future earnings. Allegheny objected to the use of this discount rate in arriving at the present value and appealed.

The Second Circuit approved of the district court's computation of the discount rate.⁴⁸ Speaking through Judge Lasker,⁴⁹ the court acknowledged that the role of inflation in future damage calculations was an open question under Connecticut law.⁵⁰ Since Connecticut requires the deduction of income taxes otherwise payable on gross earnings,⁵¹ the court of appeals reasoned that the

salary increases for use in computing future earnings is unusual. *See, e.g.*, *Wilkinson v. Yamashita-Shinnihon Kisen, K.K.*, 366 F. Supp. 110, 116 (D. Md. 1973).

⁴⁴ *See* *Floyd v. Fruit Indus., Inc.*, 144 Conn. 659, 672-73, 136 A.2d 918, 925-26 (1957) (income taxes must be deducted from probable lifetime earnings).

⁴⁵ 382 F. Supp. at 1287-88. The defendant's expert derived a tax rate of 16.7% on a gross income of \$16,000 per year. The plaintiff's expert, surprisingly, used figures of 23.4% for a gross income of \$16,000 and 30% for \$27,000. *Id.* at 1287. Judge Friendly, in his concurring opinion, criticized the use of a flat income tax rate. 524 F.2d at 392. *See* text accompanying note 59 *infra*.

⁴⁶ 382 F. Supp. at 1293. The district court, relying on the plaintiff's expert, considered the average returns since 1956 on several types of essentially "risk-free" investments: 3.75% for time deposits in Federal Reserve System member banks, 4.14% for deposits in all mutual savings banks, and 4.24% for deposits in some specific mutual savings banks. *Id.* The court found that the average yield of 4.64% earned by insurance companies from their investments was a reasonable return for a more sophisticated investor willing to take some risks. *Id.* The court accepted the 4.14% average earnings in mutual savings banks as representative of the return a prudent, nonsophisticated investor could expect. *Id.*

⁴⁷ *Id.* The district court took the average yearly yield of 4.14% from deposits in mutual savings banks and then subtracted the average yearly increase over the past 18 years in the Department of Labor's Consumer Price Index—2.87%. The 1.27% differential was rounded up to 1.5% and termed the "inflation-adjusted" discount rate. *Id.* The trial judge corroborated this "inflation-adjusted" discount rate by calculating real yields since 1940 on Treasury bills, 10-15 year federal bonds, and 3-5 year federal notes. *Id.* at 1293, 1309-12. He found the real yield on such securities to be 2% per year. *Id.* at 1293. The 1.5% discount rate was chosen over the 2% rate for two reasons. First, this allowed a margin of error in case unexpected increases in the rate of inflation depressed long term yields. Second, the government securities used in calculating the 2% real yield are considered the domain of the sophisticated investor, not of the damage plaintiff. *Id.* at 1294.

⁴⁸ 524 F.2d at 387-88.

⁴⁹ Judge Lasker, of the United States District Court for the Southern District of New York, was sitting by designation. *Id.* at 386 n.*.

⁵⁰ *Id.* at 387.

⁵¹ *See* note 44 and accompanying text *supra*.

lower court had "appropriately hypothesized the Connecticut Supreme Court's favorable reaction to a discount rate adjustment."⁵² After noting the speculative nature of both lost future earnings and discount rates, the majority cited increasing support from courts and commentators for considering the inflation factor in damage awards.⁵³ It concluded that, given the latitude afforded by Connecticut decisions and the historical and economic evidence before the trial court, the use of an "inflation-adjusted" discount rate was proper under Connecticut law.⁵⁴ The Second Circuit expressly reserved the question of whether such an inflation adjustment would apply to cases arising under federal law.⁵⁵

In a concurring opinion, Judge Friendly expressed "the gravest doubts" concerning the propriety of adjusting the discount rate for inflation.⁵⁶ He joined the majority only because the decision would not have any precedential value in similar cases under federal law since it was a diversity case applying Connecticut law.⁵⁷ Judge Friendly noted that there was little difference in result between the method of adjusting the discount rate approved by the majority and the alternative approach of estimating future earn-

⁵² 524 F.2d at 387.

⁵³ *Id.* at 387-88.

⁵⁴ *Id.* at 388. See *Quednau v. Langrish*, 144 Conn. 706, 714, 137 A.2d 544, 549 (1957) (whether jury could consider inflation left open); *Floyd v. Fruit Indus., Inc.*, 144 Conn. 659, 672-73, 136 A.2d 918, 925-26 (1957) (income taxes must be deducted from probable lifetime earnings); *Chase v. Fitzgerald*, 132 Conn. 461, 470, 45 A.2d 789, 793 (1946) (lost future earnings must be discounted to present value).

⁵⁵ 524 F.2d at 387. In *McWeeney v. New York, N.H. & H.R.R.*, 282 F.2d 34 (2d Cir.), *cert. denied*, 364 U.S. 870 (1960), the Second Circuit upheld the trial court's refusal to give an instruction concerning the nontaxability of damage awards and mentioned the offsetting effect of inflation. The court noted its lack of authority for charging the jury to consider inflation, yet stated that inflation was here to stay. 282 F.2d at 38. Judge Friendly, who wrote a concurring opinion in *Feldman* (524 F.2d at 390-93) wrote for the majority in *McWeeney*. In *Yodice v. Koninklijke Nederlandsche Stoomboot Maatschappij*, 443 F.2d 76 (2d Cir. 1971), *cert. denied*, 411 U.S. 933 (1973), the Second Circuit again upheld the refusal of the trial judge to charge the jury with respect to inflation. However, the court stated that if inflation were to continue at its then present pace, courts might have to reconsider their traditional charge with regard to the discount rate. The court considered *Yodice* an altogether improper vehicle for such a charge, given the absence of economic data in the record and the small amount of lost future earnings involved. 443 F.2d at 79.

The Supreme Court in *Grunenthal v. Long Island R.R.*, 393 U.S. 156 (1968), upheld the trial judge's view that a jury award for lost future earnings based in part on the probability of future wage increases had support in the evidence. *Id.* at 160. The plaintiff had offered unrefuted testimony of steady wage increases for equivalent work positions in the recent past and the strong likelihood of similar increases in the future. *Grunenthal v. Long Island R.R.*, 292 F. Supp. 813, 815-16 (S.D.N.Y. 1967). Although a strict projection of plaintiff's past earnings discounted to present value would have equalled about \$100,000, the district court accepted the jury's calculation of \$150,000 in lost future earnings. *Id.*

⁵⁶ 524 F.2d at 393.

⁵⁷ *Id.*

ings with adjustments for inflation and then discounting to present value in the ordinary manner.⁵⁸

Judge Friendly criticized the selection of a flat twenty-five percent tax rate, calling it inconsistent with the court's assumption of inflated future wages and a progressive tax structure.⁵⁹ He also questioned the court's assumption that employers will be able to respond to continued inflation with equivalent wage increases.⁶⁰ There was no dissent.

III

SHOULD INFLATION BE CONSIDERED?

The principal economic argument against adjusting for inflation is that plaintiffs will be compensated for decreases in the purchasing power of the dollar by corresponding increases in the return on their invested awards.⁶¹ Plaintiffs presumably can protect themselves from inflation in either of two ways: (1) they can invest exclusively in short term securities which would yield a rate of return corresponding to changes in price levels;⁶² or (2) they can make long term investments which carry higher rates of return, thus protecting themselves if the inflation rate remains constant.⁶³

⁵⁸ *Id.* at 391. Judge Friendly calculated the award using the alternative approach to illustrate his point. While maintaining the 1.5% differential ultimately used by the district court to discount the lump sum, he calculated the present value of the lost future earnings using a 4.5% annual inflation rate and a 6% yearly rate of return. The difference in present value between the two approaches was less than \$2,000 out of approximately a quarter of a million dollars. *Id.* Friendly emphasized that using the "inflation-adjusted" discount method disguised the future salaries implicitly projected by the district court. Assuming a steady progression up the GS scale and a 4.5% annual rate of inflation, the decedent would have been earning \$122,823 in the year 2011. *Id.* at 392.

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ This phenomenon is described in P. SAMUELSON, *ECONOMICS* (9th ed. 1973):

Once an inflation has gone on for a long time and is no longer "unforeseen," an allowance for a price rise will gradually get itself built into the market interest rate. Thus, once we all expect prices to rise at 4 per cent per year, my pension funds invested in bonds and mortgages will tend to pay me 8 per cent rather than 4 per cent. This adjustment of interest rates to chronic inflation has been observed in Brazil, Chile, and indeed in almost all other countries with a long history of rising prices.

Id. at 272.

⁶² For instance, if the yield on a certain short term investment is 4% and the inflation rate is 2%, the investor is receiving a 2% real yield on his investment. If the inflation rate were to climb to 4% the next year, the yield on this investment, if responsive, should increase to 6%. See Comment, *Inflation and Future Loss of Earnings*, 27 BAYLOR L. REV. 281, 286 (1975).

⁶³ For example, assuming that in a period of 3% inflation the plaintiff must earn 5%

There are specific problems with both solutions. Investment in short term securities would require frequent market trading and, therefore, sizeable transaction costs that would cut into the net return on the invested award. Investment in high-yield, long term securities such as high-grade municipal and corporate bonds as a hedge against inflation ignores the plaintiff's needs to make periodic withdrawals from the fund.⁶⁴ As a replacement for lost future wages, the award fund should be as accessible to the plaintiff as those wages would have been.

In addition, both solutions require a degree of investment skill that is inconsistent with compensatory principles.⁶⁵ Courts usually assume that plaintiffs will exercise the skill of a prudent, nonsophisticated investor.⁶⁶ In *Feldman*, for example, the court suggested that deposits in mutual saving banks were "risk-free" investments that plaintiffs, as prudent nonsophisticated investors, could make.⁶⁷

Because yields on bank deposits are controlled by the Federal

on his award, an 8% corporate bond will provide such a return as long as the rate of inflation does not exceed 3%.

⁶⁴ See Peck & Hopkins, *Economics and Impaired Earning Capacity in Personal Injury Cases*, 44 WASH. L. REV. 351, 376 (1969).

⁶⁵ See, e.g., *Chesapeake & Ohio Ry. v. Kelly*, 241 U.S. 485 (1916). In establishing that damage awards for future losses should be reduced to present value (see notes 11 & 13 and accompanying text *supra*), the Supreme Court set a guideline for the type of investment return expected of plaintiffs:

We do not mean to say that the discount should be at what is commonly called the "legal rate" of interest; that is, the rate limited by law, beyond which interest is prohibited. It may be that such rates are not obtainable upon investments on safe securities, at least without the exercise of financial experience and skill in the administration of the fund . . . This, however, is a matter that ordinarily may be adjusted by scaling the rate of interest to be adopted in computing the present value of the future benefits; it being a matter of common knowledge that, as a rule, the best and safest investments, and those which require the least care, yield only a moderate return.

Id. at 490-91.

⁶⁶ See notes 34-35 and accompanying text *supra*. But see *Frankel v. United States*, 321 F. Supp. 1331 (E.D. Pa. 1970), *aff'd sub nom. Frankel v. Heym*, 466 F.2d 1226 (3d Cir. 1972). *Frankel* was a personal injury action involving a permanently disabled plaintiff who argued that inflation should be considered in computing the future cost of institutionalization. The district court suggested that the plaintiff could invest in an appreciating asset (such as land) that would keep pace with inflation and offset any possible erosion of the original award. 321 F. Supp. at 1346. This reasoning is not only inconsistent with the investment-skill guidelines laid down in *Kelly* (see note 65 *supra*) but fails to consider the necessity of regular withdrawals of both principal and interest from the award fund. This problem has been noted by commentators, none of whom advocate that plaintiffs be expected to "hedge" against inflation. See Peck & Hopkins, *supra* note 64, at 375-76; Comment, *supra* note 62, at 287; Note, *Future Inflation and the Undercompensated Plaintiff*, 4 LOY. CHI. L.J. 359, 361 (1973).

⁶⁷ 524 F.2d at 387. See note 46 *supra*.

Reserve Board and the Federal Deposit Insurance Corporation⁶⁸ and do not automatically adjust themselves in response to inflation, the Second Circuit, in suggesting such an investment, implicitly rejected the contention that plaintiff's investments should provide their own buffer against future cost-of-living increases. The *Feldman* court also properly recognized the liquidity needs of the plaintiff by basing the discount rate on savings bank deposits.

The practical argument against adjustment for inflation is that its future course is unpredictable and subject to speculation. The *Feldman* approach forcefully meets this argument. *Feldman* approved the use of a historical differential between interest and inflation rates as the appropriate method for reducing lost future earnings to present value.⁶⁹ This approach avoids individual predictions of either inflation or interest rates and, instead, recognizes a historical average differential between the two; it is no more speculative than the traditional discount rate calculation, and, in addition, the use of a historical period, incorporating both expansionary and recessionary periods of economic activity, provides a sound basis for prediction.

The method of accounting for inflation used by most courts is to adjust salaries upward for inflation and then, in a separate computation, reduce the total of future wages to present value.⁷⁰ The *Feldman* method simplifies the more conventional calculation by eliminating the need to inflate future earnings and leaves only the task of reducing the award to present value. This simplifies jury computations.⁷¹ It also shields the jury from confronting the often shocking amount of inflated future earnings before their reduction to present value.⁷²

Since inflation and interest rates are theoretically related, sound economic analysis supports the calculation of an average difference between the two as the proper basis for prediction.⁷³

⁶⁸ See 12 C.F.R. § 217.7 (1976) (Federal Reserve System controls its member banks); *id.* §§ 329.6, .7 (Federal Deposit Insurance Corp. regulates nonmember banks).

⁶⁹ See note 47 *supra*.

⁷⁰ *E.g.*, *United States v. English*, 521 F.2d 63, 75 (9th Cir. 1975).

⁷¹ See *Seaboard Coastline R.R. v. Garrison*, 336 So. 2d 423, 425 n.4 (Fla. Dist. Ct. App. 1976) (*Feldman* approach beneficial because fewer calculations involved). Some courts and commentators question jury competence to accurately make such calculations. See, e.g., *McWeeney v. New York, N.H. & H.R.R.*, 282 F.2d 34, 37 (2d Cir.) (Friendly, J.), *cert. denied*, 364 U.S. 870 (1960); Note, *Fluctuating Dollars and Tort Damage Verdicts*, 48 COLUM. L. REV. 264, 271 (1948). For an expression of confidence in a jury's ability to handle difficult calculations, see *Burlington N., Inc. v. Boxberger*, 529 F.2d 284, 293 (9th Cir. 1975) (calculation of future tax liability).

⁷² See 37 OHIO ST. L.J. 138, 144-45 (1976) (discussion of *Feldman* case).

⁷³ Consider the following simple illustration of the relationship between prices, interest

Although the *Feldman* court's use of this method may have disguised the level of annual earnings that the court implicitly projected,⁷⁴ the majority merely attempted to arrive at an appropriate discount factor to avoid undercompensating the plaintiff. The court did not predict the actual future rates of interest or inflation; it merely recognized a historical average differential between the two and projected this into the future.

An alternative method was used by the Alaska Supreme Court in *Beaulieu v. Elliott*.⁷⁵ Recognizing the effect of future inflation on the earning potential of damage awards, the *Beaulieu* court decided that the two opposing factors should be presumed equal, thus obviating the necessity of reducing to present value.⁷⁶ This approach certainly has the advantage of simplicity—neither expert testimony nor complicated damage computations are required—but it ignores the “real interest rate,” the historical differential between rates of interest and inflation.⁷⁷ The *Beaulieu* position also ignores the hypothetical income tax liability to which any future earnings would have been subject; *Feldman* considered this factor because Connecticut is one of a few jurisdictions that requires a reduction for income tax liability.⁷⁸ The *Beaulieu* approach tends to overcompensate the plaintiff and therefore, despite its simplicity, is inferior to the *Feldman* discount rate adjustment method.⁷⁹

Although those courts that have considered inflation⁸⁰ have

rates, and real interest rates:

Americans who bought government saving bonds almost a decade ago, with a nominal yield of 4¼ per cent, can actually buy less today with \$100 than with the \$75 the bonds cost—entailing a “real interest return” of less than zero per cent.

These examples stress the need to define the “real interest rate” as the “money interest rate” minus “the percentage price rise.” Thus, if the money rate is 8 per cent for Americans and the annual price rise is 5 per cent, then the true real rate of interest is $8 - 5 = 3$ per cent. So to speak, 100 market baskets of goods lent today gives you next year only 103 (not 108!) market baskets in return.

P. SAMUELSON, *supra* note 61, at 607.

⁷⁴ See note 58 *supra*.

⁷⁵ 434 P.2d 665 (Alaska 1967). See notes 34-35 and accompanying text *supra*.

⁷⁶ 434 P.2d at 671-72.

⁷⁷ See note 73 *supra*.

⁷⁸ 524 F.2d at 387. The District of Columbia, Florida, Iowa, New Jersey, and Oklahoma also require that income taxes be deducted from damage awards for otherwise taxable income. See *Runyon v. District of Columbia*, 463 F.2d 1319 (D.C. Cir. 1972); *O'Connor v. United States*, 269 F.2d 578 (2d Cir. 1959) (Okla. law); *Adams v. Deur*, 173 N.W.2d 100 (Iowa 1969); *Tenore v. Nu Car Carriers, Inc.*, 67 N.J. 466, 341 A.2d 613 (1975); FLA. STAT. ANN. § 768.18(5) (West Supp. 1976).

⁷⁹ *Contra* *Freeport Sulphur Co. v. S/S Hermosa*, 526 F.2d 300, 308-11 (5th Cir. 1976) (concurring opinion, Wisdom, J.) (admiralty case involving capital expenditure for damages to dock).

⁸⁰ See *United States v. English*, 521 F.2d 63 (9th Cir. 1975) (error not to discount to

gone a step beyond courts that steadfastly adhere to the present-value rule,⁸¹ they have not reached the best solution. Plaintiffs will be properly compensated for lost future wages only when courts follow the *Feldman* approach and consider interest, inflation, and tax factors.⁸²

CONCLUSION

Inflation upsets the rationale for a strict application of the present-value rule and prompts the introduction of expert testimony to assist the jury in establishing proper inflation and discount rates. The calculation of an inflation rate is no more speculative than the choice of a discount rate; both are examples of predictions that juries must make under a single lump-sum recovery for damages.

The Second Circuit in *Feldman v. Allegheny Airlines, Inc.* approved the use of an inflation-adjusted discount rate computed by calculating a historical differential between rates of interest on risk-free investments and rates of inflation as reflected in the Consumer Price Index. By focusing on the return from risk-free investments, the court implicitly rejected the argument that the plaintiff make other than risk-free investments to compensate for inflation.

Having also taken into account a hypothetical income tax on the future earnings, the Second Circuit's decision represents the most comprehensive solution to date dealing with compensation for lost future earnings. The use of an inflation-adjusted discount rate combines two theoretically related factors over a recent historical period. It also simplifies the often-used two-step procedure of first adjusting for inflation and then discounting to present value.

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present value or take inflation into account—no mention of income tax liability); *Bach v. Penn. Gen. Transp. Co.*, 502 F.2d 1117 (6th Cir. 1974) (consideration of inflation held proper—no mention of income tax exclusion); *State v. Daley*, 153 Ind. App. 330, 287 N.E.2d 552 (1972) (proper to include 5% yearly wage increase—no mention of income tax liability); *Resner v. Northern Pac. Ry.*, 161 Mont. 177, 505 P.2d 86 (1973) (no mention of income tax exclusion). *But see Deweese v. United States*, 419 F. Supp. 170 (D. Colo. 1976) (consideration of inflation improper—deduction of taxes required).

⁸¹ See, e.g., *Johnson v. Penrod Drilling Co.*, 510 F.2d 234 (5th Cir.), *cert. denied*, 423 U.S. 839 (1975) (error to consider inflation but calculated future earnings must be reduced to present value).

⁸² *Accord*, *Tenore v. Nu Car Carriers, Inc.*, 67 N.J. 466, 341 A.2d 613 (1975) (error for lower court to exclude evidence of inflation and income tax exclusion). For a discussion of this case, see note 36 *supra*.