Litigation Economics SERIES

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What Litigators and Insurers Need to Know About the U.S. Interest Rates

One of the leading topics in financial markets has been the recent pattern of increased interest rates. Many expect these increases to result in a recession. Indeed, the somewhat Inverted Treasury Yield Curve, is a semi-accurate predictor, or at least often precursor of many recessions. The recent Federal Reserve policies are designed to slow down inflation. This is a result of a blunder by the Fed, and its chairman Jerome Powell, a non-economist with no graduate training at all in the field of economics, who kept pouring in stimulus into the economy and the real estate market even though the economy was red hot. The Fed kept rates close to zero and allowed the money supply to increase by the most it has in a half century. When it started to raise rates, it did so feebly and then quickly reversed course when the market responded negatively. Then time passed, the Ukraine war started, and major supply disruptions occurred. This combined with the over-the-top Biden fiscal stimulus left the nation's economy in a very high inflation environment. Then, the Powell led Fed tried to play catch up for its incompetence and the U.S. economy and holders of 401(k) and retirement plans are paying the price.

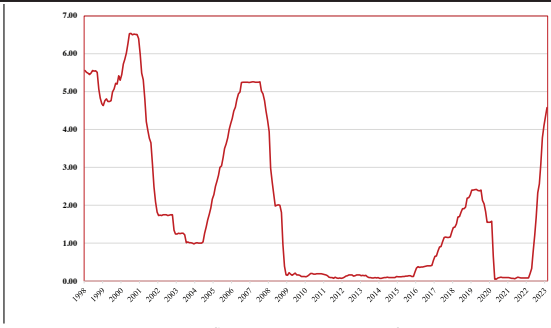
Impact on Litigants

What does the higher interest rate environment mean for litigants? It depends on the jurisdiction. The reason is *higher interest rates* means *higher discount rates* which cause the present value of projected future economic losses to be lower. This is very important for defendants who need to make sure that plaintiff's economists projecting damages are using discount rates which reflect *the relevant higher interest rate environment* we are in. Expert reports that were authored before the recent higher interest rates likely need to be challenged if they have not been amended accordingly.

Long Term Treasury Rate 1998 to Present

Source: Federal Reserve

Federal Funds Rate 1998 to Present



Source: Federal Reserve Bank of New York

General Reasoning

In Federal Court, personal injury damages are reduced to present value which is the same thing as saying they are *discounted* to present value using a specific discount rate. In state courts, discounting rules can differ. For example, in New York State, personal injury damages are presented at trial without discounting and the "discounting" takes place in a post-trial process, pursuant to Article 50-B, which is not actual discounting and unlike normal discounting, actually increases, not decreases, the losses. Still, higher interest rates will lower damages more in New York State in that post-trial process relative to what they would be in a lower interest rate environment. Across the Hudson River in New Jersey, losses are discounted in a more normal process that is similar to Federal Court rules.

In personal injury lawsuits, the discount rate often assumed is derived from safe, low risk, investments such as U.S. Treasury bonds. Whether this is a correct view is a separate issue as realizable rates of return from a reasonable portfolio are typically well in excess of the rates of Treasuries. Nonetheless, courts have expressed a preference for the returns on low-risk investments for discounting in personal injury (not commercial) lawsuits – even if their reasoning is misguided and flawed.

Simple Discounting Example

As an example, if we assume a plaintiff has lost $100 next year, and we have a trial now and award that $100 one year "early", then the plaintiff could invest that award at some rate. If, let's say the current medium term Treasury rates are 2%, then an award of $100 would overcompensate that plaintiff as the plaintiff would have one year of interest, $2, plus the $100, by next year. So, to award the plaintiff just what he or she would have lost, we would award $98 (roughly – simplistic example) and it will be $100 one year from now when we add the $2 of interest. Alternatively, if we assume that the plaintiff will lose $100 four years from now, as an example, then we need to provide even less money as the plaintiff would earn four years of interest – not just one year. If we forget about compounding, the plaintiff should only get $92 (really $92.38) and would get the remaining $8 from interest.

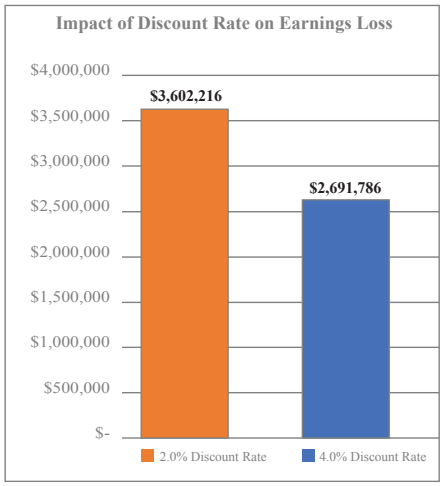
If the relevant interest rate was higher, the plaintiff could earn more interest (called a return) on an award that is received "early" on the trial date, then the present value of the damages (the amount the defendant should pay the plaintiff) would be lower as we would be using a higher interest or discount rate to reduce the future loss amount to present value.

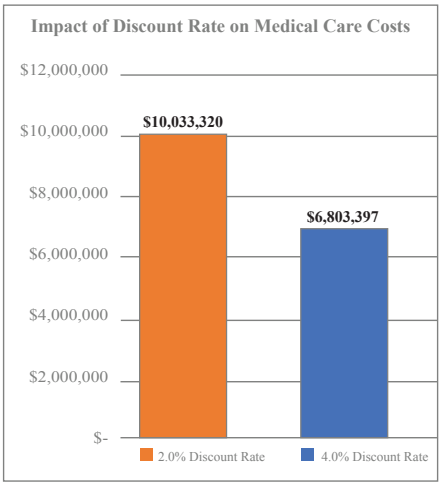
Basic Discounting Rules

The higher the discount rate, the lower the present value of the loss. Below is a very simplistic example as the earnings discount rate should take into account the earnings history and the life care plan discount rate should feature many different growth rates specific to the type of care needed. We ignore such issue in this very simple example.

Simple Example

Consider the following simple example involving a hypothetical injured plaintiff who will lose $100,000 per year of employment-related earnings and benefits, which we grow at 3% for approximately 30 years (not to imply that such a general rate is appropriate for most plaintiffs), and who also will incur medical care costs of $200,000 per year for approximately 40 years also growing at 3%. We show how the present values would differ if we used a 2% versus a 4% discount rate. The comparative values are shown in the figures below.





It is clear that just a 2% increase in the discount rate, has a significant effect on the loss of earnings, which is $900,000 lower ($910,430) and the care costs which are $3.2 million ($3,229,923) lower! Thus, interest rates/discount rates matter. The higher the amount at issue, and the longer the time period involved, the more important the coming interest rate increases become for litigators and insurance companies. Defendants settling cases that utilize low interest rates that applied to in a previous low interest rate environment may pay a higher present value of losses.

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