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RESPONSE

DON'T TILT THE PLAYING FIELD: A RESPONSE TO POLSKY AND MARKEL

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FROM modest beginnings in eighteenth-century England, punitive damages have developed into a potent legal weapon. Professors Polsky and Markel would now make that weapon even more powerful by allowing expert testimony concerning the deductibility of punitive damages from taxable income.[1] The Professors envision an expert explaining to the jury the rule regarding deductibility and explaining how the jury could increase the amount of a punitive damages award to offset the effect of the deduction. Their principal rationale is that, otherwise, the defendant's true cost will be less than the jury intended and less than it deemed necessary for punishment.

This is a solution in search of a problem. As the Professors acknowledge, plaintiffs "have not been seeking to introduce tax evidence against defendants when seeking punitive damages."[2] The probable explanation is that plaintiffs' attorneys would prefer to appeal to jurors' anger rather than their intellect. That preference is not likely to disappear.

But even if some plaintiffs were to offer expert testimony of the kind that the Professors contemplate, such testimony should be excluded. *First*, receiving testimony about deductibility would tilt the playing field in favor of plaintiffs, since juries usually are not informed either (a) that

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[1] Gregg D. Polsky & Dan Markel, Taxing Punitive Damages, 96 Va. L. Rev. 1295, 1345 (2010).

[2] Id. at 1301.

compensatory damages based on lost wages are not included in determining plaintiffs' taxable income, even though the wages they replace would have been taxed, or (b) of collateral sources of compensation such as health insurance and disability benefits. *Second*, admitting expert testimony about the deductibility of punitive awards would exacerbate the distorting effects of admitting evidence of the wealth of corporate defendants. *Third*, giving effect to the jury's intent is less significant with respect to the amount of punitive damages than with respect to most other issues submitted to the jury.

I.R.C. SECTION 104(A) AND THE COLLATERAL SOURCE RULE

In most states, adoption of the Polsky-Markel proposal would create a substantial pro-plaintiff imbalance. Under Section 104(a) of the Internal Revenue Code, compensatory damages awarded on account of personal physical injuries or physical sickness are not included in taxable income.[3] If the jury is not instructed about this rule where compensatory damages are sought on the basis of wages lost as a result of an accident, it may well award more than what the plaintiff would have received if there had been no accident and the plaintiff had earned the wages and paid the tax due. But "the overwhelming majority of courts have held that *no* such instruction should be given";[4] that is, the jury should not be told that its award would be exempt from taxes.

Courts have offered different rationales for this result. Some say an instruction about nontaxability would make trials unduly complicated or would confuse the jury.[5] Others say that, absent an instruction, jurors are

[3] See 26 U.S.C. § 104(a) (2006).

[4] 3 Jacob A. Stein, Stein on Personal Injury Damages § 15:14, at 15–51 (Gerald W. Boston ed., 3d ed. 1997); see, e.g., Vasina v. Grumman Corp., 644 F.2d 112, 118 (2d Cir. 1981) (applying New York law); Johnson v. Husky Indus., 536 F.2d 645, 650 (6th Cir. 1976) (applying Tennessee law); Combs v. Chi, St. Paul, Minneapolis, & Omaha. Ry. Co., 135 F. Supp. 750, 757 (N.D. Iowa 1955) (applying Iowa law); Henninger v. S. Pac. Co., 59 Cal. Rptr. 76, 81 (Cal. Ct. App. 1967); Polster v. Griff's of Am., Inc., 514 P.2d 80, 83 (Colo. App. 1973), rev'd on other grounds, 520 P.2d 745 (Colo. 1974); Klawonn v. Mitchell, 475 N.E.2d 857, 860–61 (Ill. 1985); Highshew v. Kushto, 134 N.E.2d 555, 556 (Ind. 1956); Spencer v. Martin K. Eby Constr. Co., 350 P.2d 18, 24 (Kan. 1960); Louisville & N.R. Co. v. Mattingly, 318 S.W.2d 844, 848 (Ky. 1958); Eriksen v. Boyer, 225 N.W.2d 66, 73 (N.D. 1974); Coleman v. N.Y. City Transit Auth., 332 N.E.2d 850, 855 (N.Y. 1975); Gradel v. Inouye, 421 A.2d 674, 680 (Pa. 1980); Turner v. Gen. Motors Corp., 584 S.W.2d 844, 853 (Tex. 1979).

[5] See, e.g., *Polster*, 514 P.2d at 83; *Klawonn*, 475 N.E.2d at 860–61; *Highshew*, 134 N.E.2d at 556 ("Inquiries at a trial into the incidents of taxation in damage suits . . . would involve intricate instructions on tax and non-tax liabilities with all the regulations pertinent

no more likely to act on the basis of an erroneous assumption that an award would be taxable than on an erroneous assumption about any other extraneous factor.[6] Other courts assert that the amount of tax that would have to be paid on future earnings is too conjectural to be considered.[7] Another rationale is that an instruction on nontaxability would nullify the Code provision excluding certain compensatory awards from income.[8] And some courts simply label tax liability "collateral."[9]

Many of the decisions probably have been driven by a desire to make plaintiffs whole despite the contingent fee—typically one-third or more of the award—that a successful personal injury plaintiff usually must pay to his attorney. In light of the contingent fee, an award equal to the after-tax wages lost by the plaintiff would not put the plaintiff in as good a financial position as he would have been in had there been no tortious conduct and had he earned the wages and paid the tax due. Not telling the jury that its award will be excludible from income is a rough way of making up for the plaintiff's inability to recover attorney's fees from the defendant. This motivation is evident from some of the opinions. One court observed that "the incidence of income tax is no more relevant to the amount of the award . . . than the amount of [the plaintiff's] contingent attorney fees, if any."[10] Another decision asked, "if a court is required to instruct on nontaxability of damages, why should it not also instruct on the impact of other factors affecting the award, such as contingency fees and court costs?"[11]

Whatever the rationale for keeping juries in the dark about the exclusion of compensatory awards from taxable income, that rule prevails in a large majority of states. Professors Polsky and Markel make much of the Supreme Court's contrary decision in *Norfolk & Western Railway Co. v.*

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thereto. No court could, with any certainty, properly instruct a jury without a tax expert at its side."); *Combs*, 135 F. Supp. at 757 ("[T]he injection of the question of income tax liability into jury cases would probably give rise to more problems than it would solve.").

[6] See, e.g., *Klawonn*, 475 N.E.2d at 860.

[7] See Blake v. Clein, 903 So. 2d 710, 730 (Miss. 2005); St. Johns River Terminal Co. v. Vaden, 190 So. 2d 40, 42 (Fla. Dist. Ct. App. 1966).

[8] See, e.g., *Eriksen*, 225 N.W.2d at 74.

[9] See, e.g., Hansen v. Johns-Manville Prods. Corp., 734 F.2d 1036, 1045 (5th Cir. 1984) (applying Texas law); *Turner*, 584 S.W.2d at 853.

[10] *Eriksen*, 225 N.W.2d at 74; see also Barnette v. Doyle, 622 P.2d 1349, 1367 (Wyo. 1981) ("[N]or do we believe that a jury should be instructed on federal taxes when it is not also instructed as to the effect of the cost of attorneys fees, the costs incurred in preparing the case or the various types of insurance that may be involved.").

[11] Stover v. Lakeland Square Owners Ass'n, 434 N.W.2d 866, 871 (Iowa 1989).

Liepelt.[12] But that case involved a cause of action under federal law. A very high percentage of the tort actions in which punitive damages are available are based on state law and most courts have refused to extend *Liepelt* to state-law causes of action.[13]

In most states, moreover, the collateral source rule excludes evidence of reimbursement for economic losses such as medical expenses and lost wages pursuant to, for example, health insurance or government programs providing disability benefits.[14] The collateral source rule constitutes an "exception" to the general principle of compensatory damages that "the plaintiff is not ordinarily entitled to a windfall recovery beyond the losses suffered as a result of the tortfeasor's conduct."[15]

The collateral source rule has been defended as "partially serv[ing] to compensate for the large portion of the plaintiff's recovery that ordinarily must be paid to his or her attorney."[16] The rule also has been defended on the ground that, even when the plaintiff receives compensation from a collateral source, absent a damages award the defendant would "in no way" be "held responsible for his or her conduct" in causing the plaintiff's loss.[17] This second rationale is really another way of saying that the defendant should be sanctioned even when an award is not necessary for compensation. And, indeed, as Judge Henry Friendly observed, "[m]any awards of compensatory damages doubtless contain something of a punitive element."[18]

It would introduce an inequitable imbalance for trial judges now to receive expert testimony that punitive awards are deductible, when defendants generally are barred from (a) informing juries that compensatory awards are excluded in calculating taxable income or (b) presenting evidence of collateral sources of reimbursement for the plaintiff's losses. Defendants would be deprived of the opportunity to inform juries of a tax rule and payments that would encourage smaller compensatory and punitive awards (particularly since the harm to the plaintiff is often a factor the jury is instructed to consider in setting punitive damages[19]),

[12] 444 U.S. 490 (1980); see, e.g., Polsky & Markel, supra note 1, at 1312–13.
[13] See, e.g., *Hansen*, 734 F.2d at 1045; *Klawonn*, 475 N.E.2d at 859–61; *Stover*, 434 N.W.2d at 869–71; *Blake*, 903 So. 2d at 730; *Barnette*, 622 P.2d at 1365–67.
[14] See 2 Stein, supra note 4, § 13:1, at 13-3 to -4 & n.4.
[15] Id. § 13:1, at 13-3.
[16] Id. § 13:2, at 13-10.
[17] Id. § 13:2, at 13-9.
[18] Roginsky v. Richardson-Merrell, Inc., 378 F.2d 832, 841 (2d Cir. 1967).
[19] See, e.g., Exxon Shipping Co. v. Baker, 554 U.S. 471, 481 (2008).

while plaintiffs would be free to inform juries of a tax rule that would encourage larger punitive awards. The lack of evenhandedness would be clear.

THE DISTORTING EFFECTS OF EVIDENCE OF CORPORATE WEALTH

An additional problem with the Polsky-Markel proposal is that existing law is already skewed in favor of overly large punitive awards against organizational defendants because of the way it treats evidence of wealth. In both civil and criminal cases, evidence of a litigant's wealth is generally inadmissible.[20] "[J]ustice is not dependent upon the wealth or poverty of the parties"[21] and "[e]vidence of a defendant's considerable wealth tends to prejudice the jury against the defendant."[22]

In cases involving punitive damages, a different rule regarding evidence of wealth emerged. The early cases approving punitive damages involved actions against individual defendants, not corporations or other entities.[23] Because wealth was deemed to be related to the amount of punitive damages necessary to deter a person from repeating the misconduct, the rule developed that evidence of the defendant's wealth could be received to help the jury choose the proper level of punitive damages. "The theory [was] that a penalty which would be sufficient to reform a poor man is likely to make little impression on a rich one; and therefore the richer the defendant is the larger the punitive damage award should be."[24]

Later, when plaintiffs sought punitive damages from corporate defendants, the rule that had been announced in cases involving individual defendants was followed without analysis.[25] Today, the most important

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[20] See, e.g., Blankenship v. Rowntree, 219 F.2d 597, 598 (10th Cir. 1955) (noting that evidence of wealth "tends to inject into the case a foreign, diverting, and distracting issue which may effect prejudicial results").

[21] Draper v. Airco, Inc., 580 F.2d 91, 95 (3d Cir. 1978).

[22] Baker v. Pa. Nat'l Mut. Cas. Ins. Co., 536 A.2d 1357, 1362 (Pa. Super. Ct. 1987), aff'd, 559 A.2d 914 (Pa. 1989).

[23] See, e.g., Coryell v. Colbaugh, 1 N.J.L. 77 (1791); Huckle v. Money, (1763) 95 Eng. Rep. 768 (K.B.).

[24] Clarence Morris, Punitive Damages in Tort Cases, 44 Harv. L. Rev. 1173, 1191 (1931); see also id. at 1191 n.31 (citing cases). For a more modern statement of this rationale, see Hall v. Montgomery Ward & Co., 252 N.W.2d 421, 424 (Iowa 1977) ("[W]hat would be 'smart money' to a poor man would not be, and would not serve as a deterrent, to a rich man.") (quoting Suzore v. Rutherford, 251 S.W.2d 129, 131 (Tenn. Ct. App. 1952)) (internal quotation marks omitted).

[25] See, e.g., Herman v. Hess Oil V.I. Corp., 524 F.2d 767, 772 (3d Cir. 1975).

cases in which punitive damages are at stake are against corporations; most courts still admit evidence of the corporate defendants' wealth.[26]

Yet, particularly where a large corporation is involved, there are compelling reasons to exclude such evidence. The Supreme Court has recognized that "the presentation of evidence of a defendant's net worth creates the potential that juries will use their verdicts to express biases against big businesses."[27] The evidence has an "undue tendency to suggest decision on an improper basis"[28] and often should be excluded under Federal Rule of Evidence 403 or a similar state rule. Any probative value is small or non-existent since corporate behavior is affected by *marginal* costs, including penalties, regardless of the corporation's wealth. In the words of the Seventh Circuit, "[c]orporate assets finance ongoing operations and are unrelated to . . . the size of the award needed to cause corporate managers to obey the law."[29] Anyone who thinks that Wal-Mart, for example, does not try to save ten thousand dollars when it can is not familiar with how large companies operate. As an American Law Institute study concluded, "[u]se of evidence of the defendant's wealth in calculating punitive damages against organizational defendants . . . cannot be justified even by the rationale of economic deterrence, let alone of retributive punishment."[30]

Nevertheless, most courts still admit evidence of corporate defendants' wealth.[31] Especially since the net worth of many corporations is in the tens or hundreds of millions or even billions of dollars, the result is to inject into trials figures that can readily lead to excessive punitive damages. To receive expert testimony about the deductibility of punitive awards would worsen the problem.

[26] See, e.g., Myers v. Cen. Fl. Invs., Inc., 592 F.3d 1201, 1216 (11th Cir. 2010).
[27] State Farm Mut. Auto. Ins. Co. v. Campbell, 538 U.S. 408, 417 (2003) (quoting Honda Motor Co. v. Oberg, 512 U.S. 415, 432 (1994)).
[28] Fed. R. Evid. 403 advisory committee's note.
[29] Zazú Designs v. L'Oréal, S.A., 979 F.2d 499, 508 (7th Cir. 1992) (Easterbrook, J.) (addressing penalty for contempt of court); see Yund v. Covington Foods, Inc., 193 F.R.D. 582, 587 (S.D. Ind. 2000) (following *Zazu Designs* and holding that "a corporation's net worth is irrelevant to the assessment of punitive damages against it"); Thomas v. E.J. Korvette, Inc., 329 F. Supp. 1163, 1170 (E.D. Pa. 1971) ("[I]t is probably safe to assume that any substantial amount of punitive damages would have deterrent effect, irrespective of the size of the corporate defendant."), rev'd on other grounds, 476 F.2d 471 (3d Cir. 1973).
[30] 2 Am. Law Inst., Reporters' Study on Enterprise Responsibility for Personal Injury 255 (1991).
[31] See supra note 26.

To their credit, the Professors acknowledge that their article assumes that "wealth-adjusted penalties are reasonably imposed on business entities."[32] They refer to an unpublished manuscript by Professor Markel in which he seeks to provide a justification for that assumption.[33] Professor Markel should consider tendering the manuscript for publication so the strength of his arguments can be tested.

THE JURY'S INTENT IS NOT THE BE-ALL AND END-ALL

The Polsky-Markel proposal also assumes that it is critically important to carry out the jury's intent with respect to how severely the defendant should be punished.[34] But fidelity to the jury's intent does not have the importance that it would with respect to most other issues submitted to the jury. It is preferable that responsibility for deciding how much the defendant should pay in punitive damages be shared, with the jury making the first determination but the trial judge and the appellate court(s) also playing an important role.

There are two main reasons that judges should play a major role in determining the proper level of punitive damages (even apart from their responsibility to enforce the constitutional prohibition against excessive punitive damages[35]).

First, jurors' anger or passion may lead them to impose an unduly harsh penalty. Courts have recognized this danger for a very long time. As the Supreme Court of Texas said in an 1890 case involving a punitive award, stunning at the time, of $10,000:

> A power such as may be exercised by juries in awarding exemplary damages is liable to great abuse,—may often lead to great oppression; and there is no class of cases in which the conservatism of the judge should more frequently find field for action. In cases based on facts which merit condemnation, or even punishment, . . . juries, under commendable impulses, but with judgment warped by passion, no doubt often render excessive verdicts . . . . The matter is in the dis-

[32] Polsky & Markel, supra note 1, at 1308 n.29.
[33] Id.
[34] See Polsky & Markel, supra note 1, at 1297 (asserting that "business defendants in punitive damages cases are typically under-punished relative to the jury's intentions").
[35] See, e.g., State Farm Mut. Auto. Ins. Co. v. Campbell, 538 U.S. 408, 416, 429 (2003).

> cretion of the jury in the first instance, but is the duty of the judge to see that this discretion is not abused.[36]

Second, the principal purpose of jury trials in civil cases is "to assure a fair and equitable resolution of factual issues,"[37] but choosing the amount of a penalty is not a predominantly factual determination. As one Oregon judge put it, "In the trial of a criminal case the jury finds the facts and two days thereafter the judge imposes sentence. I have never heard it suggested that the judge in so doing is finding the facts."[38] Similarly, writing for seven Justices, Justice Stevens explained: "A jury's assessment of the extent of a plaintiff's injury is essentially a factual determination, whereas its imposition of punitive damages is an expression of its moral condemnation. . . . Unlike the measure of actual damages suffered, which presents a question of historical or predictive fact, the level of punitive damages is not really a 'fact' 'tried' by the jury [within the Re-Examination Clause of the Seventh Amendment]."[39]

In a 1996 decision, the Fourth Circuit, noting that "in criminal cases, our system gives juries virtually no role, except in capital cases, to determine the amount of penalties," sensibly concluded that, "when reviewing the *amount* of a jury's punitive damage award . . . , the district court has a participatory decisionmaking role that it does not have when reviewing a jury's findings based solely on facts."[40] Most courts have not been so explicit,[41] but many have indeed taken a more active role in reviewing punitive awards than in reviewing a typical jury verdict.[42]

[36] Tynberg v. Cohen, 13 S.W. 315, 317 (Tex. 1890).
[37] Colgrove v. Battin, 413 U.S. 149, 157 (1973).
[38] Van Lom v. Schneiderman, 210 P.2d 461, 475 (Or. 1949) (Brand, J., concurring in part and dissenting in part).
[39] Cooper Indus., Inc. v. Leatherman Tool Group, Inc., 532 U.S. 424, 432, 437 (2001) (quoting Gasperini v. Ctr. for Humanities, Inc., 518 U.S. 415, 459 (1996) (Scalia, J., dissenting)) (citation and quotation marks omitted); see also id. at 438 n.11 (noting that in the modern era "the theory behind punitive damages has shifted toward a more purely punitive (and therefore less factual) understanding").
[40] Atlas Food Sys. & Servs. v. Crane Nat'l Vendors, 99 F.3d 587, 594 (4th Cir. 1996).
[41] See, e.g., Gilbert v. St. Louis-S.F. R. Co., 514 F.2d 1277, 1280 (5th Cir. 1975) (upholding a remittitur that reduced a punitive award by nearly seventy-five percent and explaining that "[c]ompensatory and punitive damages sometimes overlap in that both types may contain speculative elements, but they are not administrable in the same fashion").
[42] See, e.g., Vasbinder v. Scott, 976 F.2d 118, 121–22 (2d Cir. 1992) (reducing two $150,000 punitive awards to $20,000 and $30,000); Rowlett v. Anheuser-Busch, Inc., 832 F.2d 194, 206–07 (1st Cir. 1987) (reducing a $3 million punitive award to $300,000); Miller v. Schnitzer, 371 P.2d 824, 829, 831 n.3 (Nev. 1962) (reducing a $50,000 punitive award to $5000).

Thus, although Professors Polsky and Markel assume that it is important that the defendant suffer the penalty that the jury intended it to suffer, experience has shown that there is good reason for judges to play a major role in determining punitive damages. Accordingly, that the deductibility of punitive damages may lead to a net result that differs from what the jury contemplated should not be of great concern.

Conclusion

Considered in isolation, the proposal advanced by Professors Polsky and Markel has a certain logic. But it is in tension with how courts treat collateral sources of reimbursement and the exclusion from taxable income of compensatory damages awarded on account of personal injury or sickness, it disregards the distorting impact of evidence of corporate wealth, and it attributes undue importance to jury intent. It should not be adopted.