TORT REMEDY IN THE LAW
VERSUS
ECONOMIC RESTITUTION FOR PERSONAL INJURY AND WRONGFUL DEATH

By

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INTRODUCTION

When harm is inflicted on a victim in a tort, the victim usually incurs a cost and societies have developed tort laws in order to allow their victims the ability to recover those costs. Much of the legal literature regarding appropriate tort remedy has to do with the questions 'for what to compensate the victim' and 'who pays the cost?' Differing from the legal view, the general economic study of appropriate tort remedy focuses on efficiency in optimal tort cost reduction, namely to minimize the sum of the costs of accidents and the costs of avoiding them. And, then further within the realm of forensic economics, economists blend the views of tort remedy within the legal and economic literature with the controlling jurisdictional rules in order to calculate reasonable and reliable estimates of the necessary economic compensation to tort victims. Ideally, the legal, general economic, and forensic economic views, while not equal in scope, would work together to establish adequate mechanisms for tort victims to recover their costs.

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In this paper, we offer some comparisons between the nature of tort remedy in the law and economics and the tort damages that are often calculated in forensic economics (which are guided by jurisdictional evidentiary rules and the choice of economic methodology to calculate loss). In particular, we focus on the treatment of lost earnings as a measure of legal and economic damages. When making our comparisons, we find that economic tort remedies have the potential to stray away from the legal remedies contemplated in the law making them unreliable or unreasonable measures of loss to the tort victim. With this observation, forensic economists should routinely evaluate their methods of calculating and presenting economic losses for conformity to the legal and economic literature of adequate and efficient compensation to tort victims.

LEGAL VERSUS ECONOMIC REMEDIES FOR TORT HARM

Legal remedies for tort harm are generally vague in terminology or specification. For example, the Supreme Court stated in *Sea-land Services, Inc. v. Gaudet*[1] that tort compensation rests on "the good sense and deliberate judgment" of the trier of fact and "as in all damages awards for tortious injury, insistence on mathematical precision would be illusory and the judge or juror must be allowed a fair latitude to make reasonable approximations guided by judgment and practical experience."[2] Items for consideration in legal personal injury and tort remedy include loss of nurture, training, education, guidance, services, love, affection, care, attention, companionship, comfort, protection, consortium, loss of enjoyment of life, pain, suffering, mental anguish, grief, emotional harm, disfigurement, loss of time, loss of earnings, loss of earning capacity, loss of job-related fringe benefits, loss of household services, and, loss of financial support, among others.[3] The vagueness of personal injury tort remedy along with the

absence of measurement standards has a legal tradition in the belief that, as opposed to injury to real property, personal injury can never be adequately compensated with dollar damages.[4]

From the economic point of view, [5] tort costs are sunk costs and individuals (both the tortfeasor and victim) ought to bear the sunk costs if imposing those costs on them will have the desired impact on the reduction of costs in the future. Because the imposition on the tortfeasor of the victims out-of-pocket harm goes a long way to reducing the production of harm, an economic view of efficient tort remedy exists that limit economic damages, for example, to lost earnings and medical costs.

At some point, the legal and economic views of tort remedy have the potential to diverge from each other as the general concepts of damages in the law become restricted, and perhaps even outlawed, by agendas related to tort compensation (e.g., tort reform). In the next sections of this paper, we illustrate such divergence using as an example the legal and economic view of the loss of earnings as a compensable loss to tort victims.

LEGAL VIEW OF LOSS OF EARNINGS AS A COMPENSABLE TORT ITEM

In tort cases, the law provides for general damages and special damages. General damages are those that flow as the natural, necessary, and logical consequences of a wrongful act (e.g., pain, suffering, or disfigurement). In contrast, special damages result from the defendant's act by reason of the special circumstances of the case. For example, medical expenses and loss of earnings or diminished capacity to work are regarded as special damages because they are damages which are the natural, but not the necessary and inevitable result of the wrongful act and injury of which the complaint is made.[6]

A loss of earnings is a common proof that a personal injury occurred.[7] As explained in *Downey v. Commissioner*,[8] the consequences of an injury, such as lost wages, should not be

confused with the nature of the injury. While lost wages may be the best measure of the extent of the personal injury, the personal nature of an injury should not be defined by its effect (e.g., harm is not defined by lost earnings, but lost earnings are an indication that harm was caused).

The legal view that lost earnings are a method of pricing physical harm (not a definition of damages for physical harm) is imbedded into the federal tax code. The idea that a person's labor is not a commodity or article of commerce related to real property dates to Section 6 of the 1914 Clayton Act.[9] As early as 1918, section 104(a) (2) of the federal tax code provided that "the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness" is excludable from gross income. The regulations promulgated under section 104(a)(2) provide that "damages received" means an amount received from an action based upon tort or tort-type rights.[10] The law is well settled that the tax consequences of an award for damages depend upon the nature of the litigation and on the origin and character of the claims adjudicated, and not upon the validity of those claims.[11] If a taxpayer receives a damage award for a physical injury, which almost by definition is personal, the entire award is excluded from income even if all or a part of the recovery is determined with reference to the income lost because of the injury.[12]

If lost earnings are deemed as a definition of tort damages, the seeming inconsistency of not taxing income lost due to personal injury that would have normally been taxed if the injury had not occurred is illustrated in *Roemer v. Commissioner*:[13]

> "Since 1918 Congress has expressly excluded from gross income tort damages received on account of personal injuries. Revenue Act of 1918 § 213(b)(6), 40 Stat. 1066. An individual who wins a personal injury suit is usually given a lump-sum award that includes an amount for items that ordinarily would be taxable, such as lost income. Although it might be logical to allocate a lump-sum award between its excludable and taxable components, the Commissioner has long excluded from income the entire monetary judgment. *See* Sol. Op. 132, I-1 C.B. 92, 93 (1922) (rights invaded and money values are incomparable, cannot tax any

> portion of sum received). The rationale behind the exclusion of the entire award is apparently a feeling that the injured party, who has suffered enough, should not be further burdened with the practical difficulty of sorting out the taxable and nontaxable components of a lump-sum award. Note, *Taxation of Damages Recoveries from Litigation,* 40 Cornell L.Q. 345, 346 (1955)."[14]

—which correlates tort damages to compensation for physical rights invaded, not restoration of lost earnings or after-tax lost earnings.

Until the passage of the Small Business Job Protection Act in 1997,[15] all damages received for a personal injury based on a tort against a natural person were not included in taxable income under §104(a)(2) of the 1954 Internal Revenue Code (IRC) and the 1986 IRC as amended. The relevant parts of Section 104 now include delineation between damages for personal physical injuries or sickness and damages for emotional distress. If the claim is based on a physical injury or physical sickness, then all damages other than punitive damages are treated as payments received on the account of the physical injury. For example, in the case of a fall causing broken bones, all of the compensatory damages for emotional distress and mental anguish are tax-free. However, damages for emotional distress and mental anguish in cases not involving physical injury are subject to income tax. For example, if nonphysical employment discrimination produced mental collapse and the worker received psychiatric treatment, only the recovery for psychiatric expenses would be tax-free; any other recovery would be taxed. The new tax law opens the door to expert testimony (indeed may require it from each party's perspective) as to whether injuries are "physical" or constitute "emotional" consequence solely.[16]

The key to understanding the rationale for the tax treatment of personal injuries held by the majority of the Supreme Court is found in *U.S. Commissioner v. Schleier*[17] *and Dotson v. United States.*[18] From these cases, the key is the proof that damages received resulted from a "tort or tort-like" claim and also "on account of personal injury."[19] The successful plaintiff, seeking to minimize taxes, needs to show personal injury, not just economic loss, and make clear the tort-

like characteristics of their claim.[20] Where the settlement or judgment is deemed taxable, the plaintiff may or may not include that portion payable to his or her attorney due under a contingency fee arrangement.[21]

When the *Roemer* case was at the tax court level,[22] one judge's dissent in the case illustrated the inconsistency of not taxing lost earnings in the case of a young surgeon who loses a finger because of the tortuous conduct of another. This injury will surely cause the surgeon compensable general damages, such as physical and emotional pain and suffering, but it will also undoubtedly cause special damages including loss of future income. In order to prove the extent of the damages flowing from a clearly personal injury, the surgeon will likely produce evidence of both his actual pain and suffering and his loss of income. However, because it is easier to place a present dollar value upon the loss of future income than upon an intangible such as emotional pain, the surgeon will quite predictably place greater emphasis on lost income as a measure of his damages and will perhaps, thereby, receive a greater recovery. In such a case, the entire damage award or settlement amount received will be excluded from income.[23] The fact that the tortuous conduct causing the severed digit manifested itself in the loss of future income to the surgeon raises no troubling questions within the tax code as to the exclusion of the award.[24]

ECONOMIC VIEW OF LOSS OF EARNINGS AS A COMPENSABLE TORT ITEM

From the perspective of a forensic economist, Schieren reviews the economic framework of tort damages and finds that the economic analysis of tort remedy rests on the objective of achieving economic efficiency, but he also finds that defining the efficient point of tort remedy is problematic.[25] He notes that some researchers, and most legal cases, have viewed appropriate economic portion of tort remedy damages as the loss of the earnings of the victim. However,

Schieren finds that when studying the economic analysis of tort remedy in terms of the victim's lost economic utility, a remedy limited to loss of earnings does not equal the pecuniary damages of the victim, or the loss of earnings as a primary component of tort remedy is not enough to compensate the tort victim for their losses represented in their reduced economic utility.[26]

Thomas Ireland, as special editor of the *Journal of Forensic Economics*, presented a series of papers addressing the whole-time concept of economic damage in tort cases which is based on reduced utility in the usage of time.[27] As opposed to a simple lost earnings analysis, the whole-time approach involves treating tort economic losses as a function of time lost that could otherwise have been used in other ways including household production, other non-market family services, and the utilization of leisure time. Under the whole-time concept, the time spent achieving earnings is the price to pay for consumption and the economic value of time lost at consumption (measurable using a person's earning capacity) is what really shapes a tort victim's economic loss.[28] Hence, the whole-time method of addressing economic loss understands that physical harm means more than a loss of earnings, and therefore, simply compensating for lost earnings does not adequately allow for remaining economic or legal harm contemplated.

The tort reform movement has associated escalating health care costs with a perceived increase in medical malpractice tort awards and it has used this motivation, along with others, to fight for limiting the size of tort awards through a variety of means including imposing, in some states, mandatory consideration of income taxes that would have been paid had the victim not been injured or killed. For example, the 2003 tort reform activity in Texas tort culminated in revising several tort-law-related statutes and including a new statute stating that if any claimant seeks recovery for loss of earnings, loss of earning capacity, loss of contributions of a pecuniary value, or loss of inheritance, evidence to prove the loss must be presented in the form of a net

loss after reduction for income tax payments or unpaid tax liability pursuant to any federal income tax law.[29] In such tort reform actions, the amount of income taxes that would have normally been paid no longer work towards the deterrence of tort harm. For example, had victims not been injured, society would have benefited by the income taxes they would pay on their wage earnings. Law and economics recognizes that tortfeasors must pay the full amount of the victim's lost earnings to be adequately deterred from creating harm; however, under such tort reform calling for net of taxes lost earnings, the tortfeasor retains the victims' income tax amounts from the cost of harm they created; hence, under some economic views they are not adequately deterred from causing harm.

The tort reform movement has done much to modify some of the traditional means of awarding damages. As already mentioned, this has included tax adjustments as mentioned above. It also includes other issues such as joint and several liability, caps on punitive damages, obesity lawsuit reform, Appeal Bond Reform, Class Action Reform, Medical Liability Reform, Non-economic Damages Reform and several other areas of concern, including reform of the collateral source rule.[30] All of these tort reform targets have the potential of increasing the output of harm by reducing the economic price of causing harm.

COMPENSATING FOR HARM VERSUS ECONOMIC RESTITUTION

The legal view of a tort remedy is clear: the victim must be compensated for the physical harm they have suffered due to the tort. The economic view of tort remedy has a basis within utility analysis of what dollar amount would restore the victim to a near 'whole' position while adequately deterring the amount of harm created. If the goal of tort remedy is to restore an economic way of living, then simple forensic economic restitution concepts such as replacement of lost earnings or household chores might not be adequate measurements of tort remedy.

In many jurisdictions, tort remedy for personal injury is usually based on loss of earning capacity rather than a simple loss of earnings and loss of earning capacity is more related to economic utility than loss of earnings. If loss of earning capacity is defined by what dollar amount a person is capable of earning, then its simple difference from loss of earnings places an economic value on leisure time which is directly related to a person's utility.[31] For example, suppose that a person has the capacity to work to age 70, but retires at age 60. When tort remedy is based on earning capacity, a value is generated for the 10 years of actualized leisure. However, as recognized by the whole-time concept, with injury, those 10 years of leisure have a residual value to the victim that is not a part of the cost they have incurred for physical harm.

CONCLUSION

In this short paper, we have shown that the legal remedies for tort victims have the potential to differ in law, economics, and forensic economics. The legal remedy is that the victim must be compensated for the physical harm they have suffered due to the tort, and the economic remedy seeks to restore a tort victim to an economic way of living. Forensic economic remedies will differ based on jurisdictional rules and the economist's choice of an economic loss methodology. Legal remedies dictate that the consequences of an injury, such as lost wages, should not be confused with the nature of the injury, while economic and forensic economic remedies often focus of simple out-of-pocket expenses such as lost earnings and medical costs. While the forensic economist should conform to jurisdictional rules regarding the calculation damages, he or she should always remember to consider whether the economic remedy under their methodology strays so far away from the legal remedies contemplated in the law and jurisdiction to make it an unlawful, unreliable, or unreasonable measure of loss to the tort victim.

ENDNOTES

[1] 414 U.S. 573 (1974).

[2] Ibid.

[3] Loss of consortium, loss of enjoyment of life and pain and suffering are examples of non-economic damages which typically make up over fifty percent of total damages in medical malpractice and product liability cases. See A.L.I., Reporter's Study, Enterprise Responsibility for Personal Injury: Approaches to Legal and Institutional Change, 201 (1991). For an interesting article questioning the reliability of empirical studies dealing with pain and suffering, see Neil Vidmar, "Empirical Evidence on the Deep Pocket Hypothesis: Jury Awards for Pain and Suffering in Medical Malpractice Cases," 43 *Duke L.J.* 217, 235-37 (1993).

[4] See *Henshaw v. Miller*, 58 U.S. 212 (1855).

[5] For a recent discussion on tort remedy from the perspective of law and economics, see Shavell (2004).

[6] See *Wade v. Leroy*, 61 U.S. 34 (1858).

[7] See *Boston and Albany Railroad Company v. O'Reilly* (158 U.S. 334 (1895).

[8] 97 T.C. 150 (1991).

[9] The Clayton Act of 1914, 15 U.S.C. § 12-27, 29 U.S.C. §§ 52-53.

[10] 26 U.S.C.A. § 104(a).

[11] See *Bent v. Commissioner*, 87 T.C. 236 (1986).

[12] While 26 U.S.C.A. § 104(a) provides that neither damages received due to physical sickness or injuries are taxable income, whether received as a judgment or settlement and whether received as a lump sum or as periodic payments, (See 26 U.S.C.A. §104(a)(2)), this is not the case for punitive damages which are taxable. Pul. L 104-188, S 1605(a) amended 26 U.S.C.A. §104(a)(2) in 1996 clarifying that punitive damages are not be excluded from gross income when received on account of physical injuries or sickness). See also *O'Gilvie v. United States*, 136 L. Ed. 2d 454, 117 S. Ct. 452, 78 A.F.T.R.2d (P-H) ¶ 96-7454 (U.S. 1996). In this case, the court held that punitive damages were not entitled to an exclusion from taxable income even before the 1996 amendment.

[13]. Also see *United States v. Burke*, 504 U.S. 229, 119 L. Ed. 2d 34, 112 S. Ct. 1867, 69 A.F.T.R.2d (P-H) ¶ 92-1293 (1992) (criticized in *O'Gilvie* v. *United States*, 136 L. Ed. 2d 454, 117 S. Ct. 452, 78 A.F.T.R.2d (P-H) ¶ 96-7454 (U.S.)) where The Supreme Court, in a case decided under Title VII of the Civil Rights Act of 1964, held that a payment received in settlement of a back pay claim was *not* excludable from gross income, because such an award does not constitute "damages received ... on account of physical injuries." It seems the court focused on the settlement replacing the money they would have earned, but for the discrimination, but did not compensate for traditional personal injury damages. In a case involving the Age Discrimination in Employment Act (ADEA), *Downey v. Commissioner*, 33 F.3d 836, 74 A.F.T.R.2d (P-H) ¶ 94- 6015 (7th Cir. 1994), reh'g, en banc, denied, 1994 U.S. App. LEXIS 33068 (7th Cir.) and cert. denied, 132 L. Ed. 2d 827, 115 S. Ct. 2576 (U.S.), the court held that a settlement of the action was not excludable from gross income.

[14] 716 F.2d 693 (9th Cir. 1983)

[15] Pub. L. No. 104-188, 110 Stat. 1755.

[16] See Stein Treatise, Ibid, Section 16:29. Stein, Jacob A. *Stein On Personal Injury Damages*, West Publishing (2005).

[17] 515 U.S. 323, 132 L. Ed. 2d 294, 115 S. Ct. 2159, 75 A.F.T.R.2d (P-H) ¶ 95-2675 (1995)

[18] 87 F.3d 682, 78 A.F.T.R.2d (P-H) ¶ 96-5436 (5th Cir. Tex. 1996)

[19] Defamation cases yield interesting results. In the case of *Roemer v. Commissioner*, 716 F.2d 693, 52 A.F.T.R.2d (P-H) ¶ 83- 5954 (9th Cir. 1983) mentioned above, the court held that the proceeds from a judgment or settlement compensating for damaged reputation are non taxable since they come about due to personal injury. See also *Threlkeld v. Commissione*r, 848 F.2d 81, 61 A.F.T.R.2d (P-H) ¶ 88- 1285 (6th Cir. 1988) where proceeds from settlement that were attributable to malicious prosecution were not taxable since received on account of personal injuries. But, where proceeds compensate just for lost income/earnings and not for damaged reputation, the proceeds are taxable. See *Wolfson v. Commissioner*, 651 F.2d 1228, 48 A.F.T.R.2d (P-H) ¶ 81- 5351 (6th Cir. 1981); *Kurowski v. Commissioner,* 917 F.2d 1033, 66 A.F.T.R.2d (P-H) ¶ 90-5898 (7th Cir. 1990). Plaintiff's attorneys have learned to be most careful to clearly phrase their documents to maximize non-taxable proceeds in order to avoid much and sometimes all of the proceeds being subject to tax. See *Taggi v. United States*, 835 F. Supp. 744 (S.D.N.Y. 1993), aff'd, 35 F3d 93, cert. denied 493 U.S. 924, 107 L. Ed. 2d 272, 110 S. Ct. 292.

[20] See *U.S. Norfolk & W. Ry. Co. v. Liepelt*, 444 U.S. 490, 62 L. Ed. 2d 689, 100 S. Ct. 755, 10 Fed. R. Evid. Serv. (LCP) 130 (1980), reh'g denied, 445 U.S. 972, 64 L. Ed. 2d 250, 100 S. Ct. 1667 and *Jarvis v. United States*, 899 F. Supp. 320, 76 A.F.T.R.2d (P-H) ¶ 95-6046 (E.D. Mich. 1995) where monies received for recovery under a wrongful death statute were excludable. But, see 26 U.S.C.A. § 61(a)(4); *Kovacs v. Commissioner*, 100 T.C. 124 (1993), aff'd, 74 A.F.T.R.2d (P-H) ¶ 94-5001 (6th Cir.) and aff'd, 25 F.3d 1048, (6th Cir.), cert. denied, 130 L. Ed. 2d 338, 115 S. Ct. 424 (U.S.). In this case, it was held that part of the statutorily imposed interest due on damages was taxable to the plaintiff. Also see *Jarvis v. United States*, 899 F. Supp. 320, 76 A.F.T.R.2d (P-H) ¶ 95-6046 (E.D. Mich. 1995) where proceeds from the interest of a wrongful death case were deemed taxable. Also see *Brabson v. United States*, 73 F.3d 1040, 77 A.F.T.R.2d (P-H) ¶ 96- 572 (10th Cir. Colo. 1996), cert. denied. In this Colorado case, prejudgment interest due on tort damages in a personal injury case was held to be taxable. The reason given was that such interest was compensating the plaintiff for lost time value of money. This did not qualify as a common law tort remedy.

[21] See *C.I.R. v. Banks*, 125 S. Ct. 826, 94 Fair Empl. Prac. Cas. (BNA) 1793, 95 A.F.T.R.2d 2005-659 (U.S. 2005). Also see Section 703 of The American Jobs Creation Act of 2004, 118 Stat. 1418. This amended the Internal Revenue Code by adding § 62(a)(19) permitting a taxpayer, to deduct attorney fees and court costs in determining adjusted gross income. This act only applies to certain anti-discrimination statutes.

[22] See 79 T.C. 398 (1982),

[23] The Supreme Court has held that a payment received in settlement of a backpay claim under Title VII of the Civil Rights Act of 1964 is *not* excludable from gross income, because such an award does not constitute "damages received ... on account of physical injuries." On the other hand, settlement proceeds of an ERISA claim were held excludable by a federal court, on the basis that the plaintiff had received the type of traditional tort remedies contemplated by the Internal Revenue Code, i.e., the settlement compensated for dignitary injuries, emotional distress and other non-pecuniary loss, not mere contractual damages. As made clear by the Supreme Court, the determination whether a judgment or settlement is excludable under § 104(a)(2) turns on proof that the damages received were both "on account of personal injury" and stemmed from a "tort or tort-like" claim. The first requirement tests whether the damages received were due to a personal injury, rather than mere economic loss, and the second examines the legal basis of the claim for tort-like characteristics, focusing on the scope of remedies available under the statutory scheme.

[24] See also, *Threlkeld v. Commissioner*, 87 T.C. 1294 (1986).

[25] See Schieren, George A. "The Economic Framework of Personal Injury/Wrongful Death Damages" *Journal of Forensic Economics*, Vol. 11, No. 1 (1998), pp. 33-46.

[26] Ibid.

[27] See Ireland, Thomas R., "Categories of Time Use for Forensic Economics." Journal of Forensic Economics, Vol. 14, No. 1 (2001).

[28] See for example, Kruger, Albrecht, and Ward (2001).

[29] Texas statute §18.091 was added under Texas House Bill 4 (2003) to create a mandatory jury instruction regarding the net loss of earnings after the reduction for income tax payments.

[30] See the website of the American Tort Reform Association found at http://www.atra.org/, last visited 11-14-05.

[31] There are some jurisdictions that treat the plaintiff's actual lost wages that have occurred before trial as a separate element of injury. See *Nashville, C. & S. L. Ry. v. Miller*, 120 Ga. 453, 47 S.E. 959 (1904); *Reynolds v. Clark*, 28 Del. 250, 5 Boyce 250, 92 A. 873 (1914); *McCarthy v. Sebben*, 331 S.W.2d 601 (Mo. 1960). The majority of jurisdictions hold that impairment of earning capacity included pre and post trial injury. This majority view treats lost wages as evidence of a reduction in future earning capacity. See *Shea v. Rettie*, 287 Mass. 454, 192 N.E. 44 (1934).

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