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The Florida Bar
Vol. XLVII, No. 1
March 2008

The Labor & Employment Law Section

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*Advanced Labor Topics*

(#0616R)

May 9-10, 2008
Marriott Marco Island

# D.C. Circuit Court of Appeals Reverses Opinion That Encouraged Settlement of Employment Law Claims

**By Marvin Kirsner, Ashwin Trehan and Shane Muñoz**
**Greenberg Traurig, P.A.**

For a few months beginning in August 2006, both employers and plaintiffs in cases against employers appeared to benefit from a blow to the IRS. In August 2006, the D.C. Circuit had declared a provision of the Internal Revenue Code unconstitutional. As a result, plaintiffs who prevailed in certain employment cases in the D.C. Circuit could retain more of the compensation they received from their claims, and certain employment claims could be settled with less money going to the IRS. But the honeymoon did not last long. In December 2006, the D.C. Circuit vacated its August 2006 opinion and in July 2007 it restored the status quo.

In August 2006, the D.C. Circuit Court of Appeals decided *Murphy v. IRS*, 460 F.3d 79 (D.C. Cir. 2006) ("*Murphy I*"). In *Murphy I*, the Court considered whether a damages award for emotional distress and injury to professional reputation is taxable as income. Marrita Murphy had filed a complaint with the Department of Labor alleging that her former employer had "blacklisted" her and provided unfavorable references to potential employers after she had complained to state authorities about environmental hazards in the workplace. *Id.* at 81. After the Secretary of Labor ruled against Murphy's

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# Chair's Message

Greetings labor and employment lawyers and interested readers. I'm writing to provide you with an update on my administration and projections for the remainder of my term. Thus far, we experienced a very smooth transition from Cynthia Sass's term, which is normal for this section. Due to the hard efforts of prior Executive Council member Jeff Mandel and his co-chair, Michael Grogan, the Public Employment Labor Relations Forum held in Orlando during October was a grand success. The program focused on shortfall in funding and impacts on governmental entities and their employees. This was very insightful and timely given the passage of the new constitutional amendment on January 22, 2008. If you did not attend the conference and have public sector unions or employers as clients or potential clients, I strongly recommend that you procure the audio tapes for current information on this subject from the most renowned speakers.

On January 30, 2008, the Executive Council had a well-attended teleconference to consider the proposed budget for the section, which had to be passed and presented to the Bar by the following day. Our Program Administrator from the Bar, Angela Froelich, did an excellent job of scheduling the conference, passing out the proposed budget and answering numerous technical questions, many of which were raised by Chair-Elect Alan Forst. With a minor technical adjustment, the budget was passed by

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**DC CIRCUIT COURT**
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employer, the case was remanded to an Administrative Law Judge, who recommended compensatory damages totaling $70,000: $45,000 for "emotional distress or mental anguish"; and $25,000 for "injury to professional reputation" due to Murphy being blacklisted. *Id.* Murphy claimed this award as income in her tax return, and as a result paid $20,665 in additional taxes . *Id.*

Murphy then learned of Internal Revenue Code (IRC) section 104(a)(2) and amended her return, seeking a refund of the $20,665. *Id.* Section 104(a)(2) provides that "gross income does not include… damages… received on account of personal physical injuries or physical sickness." IRC §104(a)(2) (2007). In support of her refund claim, Murphy submitted to the IRS copies of her medical and dental records, which reflected anxiety attacks, shortness of breath, and other physical manifestations that Murphy alleged were a result of her employer's actions. *Murphy I*, 460 F.3d at 81. The IRS found that Murphy had failed to demonstrate that the compensatory damages she received were attributable to "physical injury" or "physical sickness", and therefore denied her request for a refund. *Id.* at 82. Undeterred, Murphy sued the IRS and the United States in the United States District Court for the District of Columbia. *Id.* The District Court granted summary judgment for the Government and the IRS, and Murphy appealed. *Id.*

Murphy made two arguments in the Court of Appeals: 1) that her compensatory damages award was in fact for "personal physical injuries" and therefore excluded from gross income under IRC Section 104(a)(2); and 2) alternatively, that Section 104(a)(2) as applied to her award was unconstitutional because the award was not "income" within the meaning of the Sixteenth Amendment, which permits Congress to tax income. *Id.* at 83-86.

Addressing Murphy's first argument, the Court of Appeals found that Section 104(a)(2) was not intended to exclude from taxation compensation for non-physical injuries, even if those injuries had physical effects. The Court's ruling with respect to Section 104 was unsurprising, because of a 1996 amendment to that section. Prior to 1996, Section 104 excluded from gross income monies received in compensation for "personal injuries or sickness." 26 U.S.C. §104(a)(2) (1995). Based on that language, there was a viable argument that a portion of an employment discrimination damage award or settlement was excluded from income if it compensated the plaintiff for non-physical but nonetheless personal injuries, such as defamation and damage to reputation. *See, e.g.*, *Roemer v. Comm'r of Internal Revenue*, 716 F.2d 693 (9th Cir. 1983) (finding compensatory damages award for defamation excludable under pre-1996 Section 104(a)(2); *see also Threlkeld v. Comm'r of Internal Revenue*, 848 F.2d 81 (6th Cir. 1988) (finding portion of settlement attributable to damage to personal reputation excludable under pre-1996 Section 104(a)(2)).

The 1996 amendment qualified the nature of tax exempt personal injury awards by limiting the exclusion to damages received "on account of personal *physical* injuries or *physical* sickness." 26 U.S.C. §104(a)(2) (2006) (emphasis added). Accordingly, after the 1996 amendment, compensation is excluded from taxable income only if it is "on account of" physical injury or physical sickness -- for example, if the award or settlement is to compensate for damages resulting from a physical assault of the employee. *See Murphy v. I.R.S.*, 362 F. Supp. 2d 206 (D.D.C. 2005); *see also Lindsey v. Comm'r of Internal Revenue*, 422 F.3d 684, 687 (8th Cir. 2005).

Despite denying Murphy's first argument, the D.C. Circuit then surprised practically everyone by accepting Murphy's alternative argument, and holding Section 104(a)(2) unconstitutional. The Court first found that when the Sixteenth Amendment was adopted, Congress did not consider

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**DC CIRCUIT COURT**
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compensation for physical injuries to be income; therefore, Congress did not intend for such compensation to be taxable under the Sixteenth Amendment. *Murphy I,* 460 F.3d at 90. Moreover, the court noted that at the time the Sixteenth Amendment was enacted, Congress did not distinguish between compensation for physical injuries and compensation for non-physical injuries. *Id.* at 91. Consequently, the Court concluded that Congress also must not have intended for compensation for *non*-physical injuries to be income taxable under the Sixteenth Amendment. *Id.* at 92. Because Section 104(a)(2) authorized taxation of compensation for non-physical injuries, the Court held that Congress had exceeded the authority to tax under the Sixteenth Amendment and held Section 104(a)(2) unconstitutional. *Id.* at 92.

In part, the Court based its ruling on the answer to the question, "In lieu of what were the damages awarded?" *Id.* at 88. The Court found that because the award Murphy received was in lieu of something normally untaxed -- namely, the reputation and emotional well-being she enjoyed prior to her employer's actions -- the award was neither a gain nor an accession to wealth, and therefore was not taxable as income under the Sixteenth Amendment. *Id.*

*Murphy I* caused an uproar among tax scholars, some of whom noted that the decision overlooked Congress' power to tax under Article I, Section 8 of the Constitution. *See e.g.* Chris Atkins, TaxPolicyBlog, The Murphy Case: Interpretive and Constitutional Issues, http://www.taxfoundation.org/blog/show/1806.html. Perhaps in response to the uproar, the Court vacated its August 2006 opinion and agreed to rehear oral arguments. *Murphy v. IRS*, No. 05-5139, 2006 U.S. App. LEXIS 32293 (D.C. Cir. Dec. 22, 2006).

In July of 2007, the Court found for the Government, holding that even if money received on account of a claim for damages is not income within the scope of the Sixteenth Amendment, it is nonetheless taxable under Congress' Article I, Section 8 power to tax and spend for the general welfare. *Murphy v. IRS*, 493 F.3d 170, 180-86 (D.C. Cir. 2007) ("*Murphy II*"). Thus, in *Murphy II*, the Court held that Section 104(a)(2) of the Internal Revenue Code *is* constitutional, and money received in compensation for a claim for damages based on non-physical injuries is subject to taxation. *Id.* at 186.[1]

After *Murphy I*, a plaintiff in the D.C. Circuit who received compensation for damages for non-physical injuries could not be taxed on this compensation. Accordingly, a plaintiff seeking to net a given amount in settlement of such a claim did not need to demand an additional sum to cover tax liability. But after *Murphy II*, a plaintiff who settles a claim for non-physical injuries will be taxed on the full amount received as damages; thus, a larger payment from the defendant will be required in order for the plaintiff to net the same amount. Therefore, under *Murphy II*, either the defendant will have to pay more in settlement or the plaintiff will net less. Hence, the reversal in *Murphy II* will likely result in fewer settlements.

Employment lawyers should be mindful, however, that the ruling in *Murphy II* does not appear to affect the deductibility from taxable income of costs and attorney's fees incurred in litigation of discrimination claims. On October 22, 2004, the American Jobs Creation Act (AJCA), was signed into law. Prior to the enactment of the AJCA, a plaintiff in an employment discrimination case was required to report the entire gross amount of the damage award, including attorney's fees, as gross income. The amount paid to the attorney could then be deducted as an itemized deduction. This itemized deduction, however, would often trigger the Alternative Minimum Tax, thereby eliminating all or part of the deduction for attorney's fees paid.

The AJCA altered this framework. The AJCA applies to claims of unlawful discrimination (including, for example, Title VII, the Americans with Disabilities Act, the Age Discrimination in Employment Act, and retaliation for bringing an action pursuant to any of these statutes), and provides in part that attorney's fees and court costs paid by or on behalf of a taxpayer in connection with such claims are deductible from income as an "above the line deduction," and therefore are fully deductible. 26 U.S.C. §62(a)(20) (2007). The statute is not retroactive, however, so it does not affect tax obligations on attorney's fees or court costs paid prior to the date it was enacted. Nonetheless, it does at least ensure that a discrimination plaintiff will be able to take an above the line deduction from taxable income for money paid to legal counsel and the court, including amounts paid to a plaintiff's legal counsel incident to a settlement agreement.

In summary, the D.C. Circuit's about-face restored the status quo. Now, as before, a plaintiff who recovers damages or settles a claim for personal injury must pay taxes on any compensation received for non-physical injuries. However, a discrimination plaintiff may fully deduct attorney's fees and court costs, meaning that a discrimination plaintiff who negotiates a settlement with an employer will not be compelled to raise his settlement demand to compensate for taxation on costs and fees.

**Endnotes:**

1 Murphy filed a petition for rehearing en banc, which the Court denied. *Murphy v. IRS,* 493 F.3d 170 (D.C. Cir. 2007) *reh'g denied en banc,* (No. 05-5139).


# CLASSIFIED ADS

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waiver of the psychotherapist-patient privilege. Historically, the majority of courts followed the broad view, although the majority of recent cases now appear to adopt some aspect of the "middle view" reasoning.

## Practical Aspects of Discovery

In the discovery context, it appears clear that a defense interrogatory requesting a plaintiff to list the names of mental health providers, including psychiatrists, psychologists, counselors, and therapists, and the dates of treatment, would not be subject to the privilege. However, plaintiffs still may argue that such an interrogatory should not be answered because the names of mental health providers and the dates of treatment are not **relevant** to a proceeding where plaintiff is seeking only "garden variety" emotional distress damages.

Ordinarily, under Fed. R. Civ. P. 26 (b)(i), parties may obtain discovery regarding, "any matter, not privileged, which is relevant to the subject matter involved in the pending action". The Rule's relevancy requirement is to be considered broadly and material is relevant if it bears on, or reasonably could bear on, an issue that is, or may be, involved in the litigation. *Oppenheimer Fund, Inc., v Sanders*, 437 U.S. 340, 350 (1978). A request for discovery should be considered relevant if there is, "any possibility", that the information sought may be relevant to the claim or defense of any party. *Merrill,* 227 F.R.D. at 470.

However, in *Miles v Century Twenty One Real Estate, LLC,* 2006 U.S. Dist. LEXIS 67974, at *9 (E.D. Ark. Sept. 21, 2006), the court considered plaintiffs' representations that they were not offering medical records, counseling records, or expert testimony to prove their emotional distress claims and found, therefore, that plaintiffs met their burden to show that the information requested [by Interrogatory No. 10] was not relevant, or of such marginal relevance that the ordinary presumption in favor of disclosure was outweighed by potential harm. Accordingly, the court denied defendant's motion to compel.

In *Miles*, 2006 U.S. Dist. LEXIS 67974 at *19-20, the court also denied defendant's Motion to Compel a response to a Request to Produce plaintiffs' mental health records based upon the same reasoning. Thus, if plaintiffs are willing to stipulate not to offer expert testimony or refer to psychological treatment at trial, discovery of prior psychiatric records possibly can be avoided, even if a court finds the privilege inapplicable.

Even in cases where records are required to be produced, courts have limited discovery. For example, in *EEOC v Consolidated Realty*, 2007 U.S. Dist. LEXIS 36384 at *5, the court held that defendant was not entitled to information regarding **every** medical treatment plaintiff ever received. Rather, discovery was had of only those treatments that related to her emotional or mental condition and that may reveal other conditions or stressors that may cause the emotional distress or illness allegedly resulting from defendant's wrongful conduct.

## Practical Aspects of Trial Testimony

Assuming that plaintiff successfully fends off what could be a lengthy and costly discovery motion seeking to compel production of psychotherapist records, what is the practical effect of this "victory"? The effect appears to be that plaintiff not only has limited the type of evidence that can be presented in support of an emotional distress claim, but also may have limited the total amount of emotional distress damages which can be awarded.

In *Santelli v Electro-Motive*, 188 F.R.D. 306 (E. D. Ill. 1999), plaintiff stipulated that her emotional damages claim was limited to compensation for humiliation, embarrassment, and other similar emotions that she experienced essentially as the intrinsic result of the defendant's alleged conduct (i.e., "garden variety" damages). As a result, the court, precluded her from introducing evidence about emotional distress that necessitated care or treatment by a physician and she was barred from introducing evidence of any resulting symptoms or conditions that she might have suffered. While it is obvious that a stipulation seeking to protect discovery of prior psychological records because a plaintiff is seeking only "garden variety" emotional distress damages bars that plaintiff from using therapists as witnesses or presenting the substance of any communication with a mental health professional, the *Santelli* court also barred plaintiff from introducing evidence of any resulting symptoms or conditions that she might have suffered. This holding would appear to rule out plaintiff testifying to any specific symptoms, such as sleeplessness, or offering any corroborative lay testimony that such symptoms were observed. This reduces plaintiff's emotional distress damages case to presenting his or her own testimony concerning the reaction to the defendant's alleged misconduct.

## Damages

Although plaintiff's own testimony may suffice to show emotional distress damages, *Bernstein v Sephora*, 182 F.Supp. 2d 1214, 1227 (S.D. Fla. 2002), such testimony of humiliation or disgust, may prevent a plaintiff from fully recovering from her alleged emotional distress, *Santelli*, 188 F.R.D. at 309.

An award of damages for emotional distress must be supported by competent evidence of genuine injury. *Carey v Piphus*, 435 U.S. 247, 264 (1978). By narrowing the scope of permissible testimony in support of a claim for emotional distress damages, in order to protect discovery of prior records, plaintiffs risk reversal of an award of emotional damages for lack of proof of a "genuine injury". See, for example, *Akouri v FL Dept. of Transportation*, 408 F. 3d 1338, 1345 (11th Cir. 2005), which reversed a $552,000 compensatory damage award and held that a plaintiff's conclusory statements were insufficient to support the award; the distress must be sufficiently articulated.

Several courts also have ordered remitters of excessive jury awards in "garden variety" emotional distress damages claims. In *Shannon v Fireman's Fund Insurance Co.*, 156 F. Supp. 2d 279, 298 (S.D.N.Y. 2001), the court remitted an $80,000 emotional suffering award to $40,000. That court looked at reviews of jury verdicts and discrimination cases

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**“GARDEN VARIETY” DAMAGES**
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which noted that “garden variety” mental anguish awards hovered in the range of $5,000 - $30,000. See also, *Bick v City of New York*, 1998 U.S. Dist. LEXIS 5543 (S.D. N.Y. Apr. 21, 1998).

## Conclusion

With a thorough understanding of the pros and cons of seeking damages only for “garden variety” emotional distress, the parties may be able to avoid expensive and protracted discovery disputes. See, for example, *Sassak v City of Park Ridge*, 2006 U.S. Dist. LEXIS 63399 at *2 (N.D. Ill. July 20, 2006), where defendants agreed not to continue to seek information regarding psychological records and treatment, if plaintiffs stipulated that they would adhere to the evidentiary limits imposed in *Santelli*. Creative parties may even stipulate to a modest amount of emotional distress damages and submit to a jury only the question of whether or not emotional distress damages were sustained. Mediation resolving this aspect of the claim is always helpful. Given the issues discussed in this article, plaintiff’s counsel will want to assess at a very early stage of the litigation whether or not to maintain a claim for “garden variety” emotional distress damages.

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### Endnotes

1. “Garden variety” emotional distress damages are those which seek recompense only for emotional injuries that are likely to arise as a fair consequence of the underlying violation. *Morrissette v Kennebec County*, 2001 U.S. Dist. LEXIS 13309 (D. Me. Aug. 21, 2001).

2. There is no Federal common law physician-patient privilege. *Anderson v Caterpillar, Inc.,* 70 F. 3d 503, 506 (7th Cir. 1995); *Merrill v Waffle House, Inc.*, 227 F.R.D. 467, 471 (M.D. Tex. 2005).

3. Other cases adopting the broad view include: *Smith v Central Dauphin School* District, 2007 U.S. Dist. LEXIS 4353 (M.D. Pa. Jan. 22, 2007); *Davis v Bemiston-Carondolet Corp*. 2006 U.S. Dist. LEXIS 9951 (E.D. Mo., Mar. 13, 2006); *Sanchez v U.S. Airways, Inc.*, 202 F.R.D. 131 (E.D. Pa. 2001); *Fox v Cates Corp.*, 179 F.R.D. 303 (D. Colo. 1998); *Allen v Cook County Sheriff’s Dept.*, 1999 U.S. Dist. LEXIS 3587 (N.D. Ill. Mar. 17, 1999); *EEOC v Danka Industries, Inc.*, 990 F. Supp. 1138 (E.D. Mo. 1997); *Vann v Lone Star Steakhouse & Saloon of Springfield, Inc.*, 967 F. Supp. 346 (E.D. Ill. 1997); *Sarko v Penn-Del Directory Co.*, 170 F.R.D. 127, 130 (E.D. Pa. 1997); *Kerman v City of New York*, 1997 U.S. Dist. LEXIS 16841 (S.D.N.Y. Oct. 24, 1997); *Topol v Trustees of the Univ. of Pa.*, 160 F.R.D. 476, 477 (E.D. Pa. 1995).

4. Other cases adopting the narrow view include: *Booker v City of Boston,* 1999 U.S. Dist. LEXIS 14402 (D. Mass. Sept. 10, 1999); *Fritsch v City of Chula Vista*, 187 F.R.D. 614 (S.D. Cal. 1999); *Hucko v City of Oak Forest*, 185 F.R.D. 526 (N.D. Ill. 1998).

5. Other cases adopting the middle view include: *EEOC v Woodmen of the World Life Insurance Society*, 2007 U.S. Dist. LEXIS (D. Neb. Feb. 1, 2007); *Greenberg v Smolka*, 2006 U.S. Dist. LEXIS 24319 (S.D.N.Y. Apr. 25, 2006); *Gaines-Hanna v Farmington Public Schools*, 2006 U.S. Dist. LEXIS 21506 (E.D. Mich. Apr. 7, 2007).

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