

NOTES

***Egan v. Mutual of Omaha Insurance Co.*: The Reasonable Relation Rule, the Tax Laws, and the Excessiveness of Punitive Damage Awards**

The principal purpose of punitive damages in California is to deter the defendant and others from committing socially objectionable conduct. Yet, all too often, punitive damage awards are significantly reduced or reversed by appellate courts. This note analyzes the rationale underlying the California Supreme Court's reversal of a \$5 million punitive damage award in Egan v. Mutual of Omaha Insurance Co.

INTRODUCTION

In *Egan v. Mutual of Omaha Insurance Co.*,¹ the California Supreme Court upheld an award of compensatory damages for breach of an insurance contract, but reversed as excessive an award of punitive damages.² The majority opinion by Justice

¹ 24 Cal. 3d 809, 598 P.2d 452, 157 Cal. Rptr. 482 (1979), *appeal dismissed, cert. denied*, 48 U.S.L.W. 3568 (Mar. 3, 1980). Petitioner Mutual claimed jurisdiction in the U.S. Supreme Court under 28 U.S.C. § 1257(2) and argued that CAL. CIV. CODE § 3294 (West 1970) is unconstitutionally vague. Petitioner's arguments on this issue are presented in Supplemental Brief for Defendants-Appellants at 2-29, *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 598 P.2d 452, 157 Cal. Rptr. 482 (1979). The California Supreme Court stated in *Egan* that the constitutionality of CAL. CIV. CODE § 3294 (West 1970) had been frequently upheld in California, *see* authorities cited in Justice Mosk's opinion, *id.* at 819, 598 P.2d at 457, 157 Cal. Rptr. at 487.

² The court reversed the trial court's determination without qualification. *Id.* at 824, 598 P.2d at 460, 157 Cal. Rptr. at 490. A judgment or order reversed without qualification restores to the parties essentially the same rights they had before the trial court made its erroneous ruling. *Weightman v. Hadley*, 138 Cal. App. 2d 831, 836, 292 P.2d 909, 915 (2d Dist. 1956). This includes the right to have the issues within the reversed portion tried anew. CALIFORNIA CIVIL APPELLATE PRACTICE § 17.6 (Cal. Cont. Educ. Bar 1966). In *Egan*, although the court

Mosk held that the punitive damage award was the result of "passion and prejudice" on the part of the jurors and therefore excessive as a matter of law.³ This note examines the court's rationale in reversing the punitive damage award. It suggests that the court's continued application of the reasonable relation rule⁴ in reviewing punitive damage awards for excessiveness bears no relation to the purpose of deterrence and infringes arbitrarily on the jury's rightful role in setting such damages. This note proposes that a standard of review based on defendant's wealth and the reprehensibility of defendant's conduct better effectuates the deterrence purpose of punitive damage awards. This note also suggests that the court may be reluctant to award plaintiff what it perceives to be a substantial windfall. This reluctance should be lessened by a change in federal law concerning the taxation of punitive damages.

reversed the trial court's award of punitive damages without qualification, the majority clearly stated that the jury was justified in finding liability for punitive damages. Therefore, on retrial, plaintiff Egan will argue that only the amount of punitive damages should be retried. (Letter to author from plaintiff's attorney Stephen L. Odgers, Esq., Jan. 28, 1980, on file at U.C. DAVIS LAW REVIEW.)

³ Egan v. Mutual of Omaha Ins. Co., 24 Cal. 3d 809, 824, 598 P.2d 452, 460, 157 Cal. Rptr. 482, 490 (1979). Justices Bird, Tobriner, and Manuel joined in Justice Mosk's decision. Justices Clark and Richardson concurred in part in separate opinions. *Id.* at 824, 834, 598 P.2d at 460, 466, 157 Cal. Rptr. at 490, 496. Both Justices agreed with the majority's judgment upholding the compensatory and reversing the punitive damage awards; but dissented from the majority's determination that a finding of liability for punitive damages was justified on the facts as presented. *Id.* at 825, 834, 598 P.2d at 460, 466, 157 Cal. Rptr. at 490, 496. Justices Clark and Richardson thought the negligent conduct of Mutual's agents did not meet the requirements of CAL. CIV. CODE § 3294 (West 1970) for imposition of punitive damages or that the agents' conduct should be imputed to Mutual for punitive damage purposes. *Id.* at 829, 834, 598 P.2d at 463, 466, 157 Cal. Rptr. at 493, 496. Justice Clark also argued that punitive damages should never be imposed for improper claims practices because insurers would pass the cost of such awards to the public in the form of increased premiums. *Id.* at 826-27, 598 P.2d at 461-62, 157 Cal. Rptr. at 491-92 (Clark, J., concurring and dissenting).

⁴ The court requires that a "reasonable relation" exist between actual damages suffered by the plaintiff and the punitive damage award. See notes 56-58 and accompanying text *infra*.

I. EGAN V. MUTUAL OF OMAHA INSURANCE CO.

A. *The Facts*

The *Egan* case involved the mishandling of an insured's claim for benefits under a health and disability insurance policy. Plaintiff Egan purchased \$200 per month coverage benefits under a health and disability insurance policy from Mutual of Omaha (Mutual) in 1962.⁵ Lifetime benefits were payable if Egan became totally disabled due to accidental injury or an illness confining him to his home.⁶ A nonconfining illness limited him to three month's payment.⁷

In May, 1970, Egan submitted a claim for an accidental back injury suffered in a fall from a roof during his employment.⁸ Only after a personal visit to the claims office in September did he receive a \$600 payment under the policy's accident provisions.⁹

In October, Egan filed a supplemental claim declaring his inability to return to work.¹⁰ In November, Mutual's claims manager visited Egan at home.¹¹ He called Egan a fraud, refused him further payments, and laughed¹² at Egan's offer to be examined by any doctor of Mutual's choice.¹³ Under financial distress¹⁴ and actually disabled,¹⁵ Egan was reduced to tears in the presence of his family.¹⁶

In February, 1971, Mutual sent Egan a "final" payment of \$626.66.¹⁷ In May, Mutual's claims adjuster reclassified Egan as suffering from a nonconfining illness.¹⁸ Mutual never contacted

⁵ *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 815, 598 P.2d 452, 454, 157 Cal. Rptr. 482, 484 (1979).

⁶ *Id.*

⁷ *Id.* A nonconfining illness is one not sufficiently severe to cause confinement of the insured to his residence.

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*

¹² *Id.* at 821, 598 P.2d at 458, 157 Cal. Rptr. at 488.

¹³ Mutual's claims manager relied on Egan's medical records immediately following the accident, wherein Egan and his physician agreed he would return to work in 1970. *Id.* at 815, 598 P.2d at 454, 157 Cal. Rptr. at 484.

¹⁴ *Id.* at 821, 598 P.2d at 458, 157 Cal. Rptr. at 488.

¹⁵ Egan received a 73% disability rating on his workers' compensation claim. *Id.* at 817, 598 P.2d at 455, 157 Cal. Rptr. at 485.

¹⁶ *Id.* at 821, 598 P.2d at 458, 157 Cal. Rptr. at 488.

¹⁷ (Letter to author from plaintiff's attorney Stephen L. Odgers, Esq., Jan. 28, 1980, on file at U.C. DAVIS LAW REVIEW.)

¹⁸ 24 Cal. 3d at 816, 598 P.2d at 455, 157 Cal. Rptr. at 485.

Egan's physicians concerning this reclassification.¹⁹ The claims adjuster visited Egan at home and tendered a check for three months' maximum benefits under the classification.²⁰ Egan did not cash this check and refused the larger check offered to him to surrender his policy.²¹

During this time, Mutual knew Egan had medical and financial problems. Egan had undergone surgery,²² for example, which left him confined to his home for medical reasons.²³ Egan also had a child and a totally disabled wife to support²⁴ and was financially insecure.²⁵

The trial court²⁶ ruled that Mutual's failure to have Egan examined by a doctor of its choice or to consult with his physicians violated the covenant of good faith and fair dealing which is implied under California law between insurer and insured.²⁷ The jury returned verdicts against all defendants.²⁸ Mutual was held

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² *Id.*

²³ *Id.* at 821, 598 P.2d at 458, 157 Cal. Rptr. at 488.

²⁴ *Id.* at 822, 598 P.2d at 458, 157 Cal. Rptr. at 488.

²⁵ *Id.* at 821, 598 P.2d at 458, 157 Cal. Rptr. at 488.

²⁶ *Egan v. Mutual of Omaha Ins. Co.*, No. 47079, Superior Court, Los Angeles County, filed February 22, 1973.

²⁷ The implied covenant of good faith and fair dealing requires that the insurer refrain from doing anything to injure the insured's right to receive the contract benefits. *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 818, 598 P.2d 452, 456, 157 Cal. Rptr. 482, 486 (1979). The insured must in addition give at least as much consideration to the insured's interests as it does to its own. *Id.* The covenant of good faith and fair dealing is well-established in California. An insurer has a duty to accept a settlement offer that a prudent insurer would accept if it alone were liable for the entire judgment. See *Johansen v. California State Auto Ass'n Inter-Ins. Bureau*, 15 Cal. 3d 9, 538 P.2d 744, 123 Cal. Rptr. 288 (1975); *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967); *Communale v. Traders and General Ins. Co.*, 50 Cal. 2d 654, 328 P.2d 198 (1958); *Murphy v. Allstate Ins. Co.*, 17 Cal. 3d 97, 553 P.2d 584, 132 Cal. Rptr. 424 (1976). An insurer must not unreasonably and in bad faith withhold payment of a claim. See *Silberg v. California Life Ins. Co.*, 11 Cal. 3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1974); *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973); *Fletcher v. Western National Life Ins. Co.*, 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (4th Dist. 1970).

²⁸ *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 817, 598 P.2d 452, 455, 157 Cal. Rptr. 482, 485 (1979). General damages of \$500 and punitive damages of \$400 were assessed against Segal, the claims adjuster. *Id.* General damages of \$1,000 and punitive damages of \$500 were assessed against McEachen, the claims manager. *Id.* The California Supreme Court reversed the judgments

liable for \$45,600 in general damages, \$78,000 for emotional distress and \$5,000,000 in punitive damages.²⁹

B. *Opinion of the California Supreme Court*

The California Supreme Court affirmed the trial court's award of compensatory damages, but reversed in all other respects.³⁰ Justice Mosk, writing for the majority, addressed four issues in *Egan*. First, he agreed with the trial court that an insurer may breach the covenant of good faith and fair dealing by failing to properly investigate its insured's claim.³¹ The court found it essential that an insurer fully inquire into possible bases supporting an insured's claim.³² The insurer's failure to thoroughly investigate and pay an insured's rightful claim subject it to tort liability in California.³³

In *Egan*, the court found undisputed evidence that Mutual had failed to thoroughly investigate its insured's claim.³⁴ This established that Mutual had breached the implied covenant of good faith and fair dealing.³⁵ The court therefore affirmed the award of compensatory damages below.³⁶

Second, the court addressed the propriety of a punitive damage award in this case. It began with a recitation of the governing

against McEachen and Segal since they were not parties to the insurance contract and not subject to the implied covenant of good faith and fair dealing. *Id.* at 824, 598 P.2d at 460, 157 Cal. Rptr. at 490.

²⁹ *Id.* at 817, 598 P.2d at 455, 157 Cal. Rptr. at 485.

³⁰ *Id.* at 824, 598 P.2d at 460, 157 Cal. Rptr. at 490. See note 2 *supra* for a discussion of unqualified reversal.

³¹ 24 Cal. 3d at 817, 598 P.2d at 455, 157 Cal. Rptr. at 485. The court stated that the extent of the obligation owed by insurers under the implied covenant of good faith and fair dealing depends on the contractual purposes of the insurance policy. *Id.* at 818, 598 P.2d at 456, 157 Cal. Rptr. at 486. The court reasoned that the insured in a contract for disability insurance seeks peace of mind and actual protection against the calamity that he will be unable to work. *Id.* at 819, 598 P.2d at 456, 157 Cal. Rptr. at 486. The *Egan* case establishes for the first time that an insurer in California may breach the duty of good faith and fair dealing by failing to fully investigate a claim. CAL. TRIAL LAW. A. FORUM, Oct. 1979, at 1, 6.

³² 24 Cal. 3d at 819, 598 P.2d at 456, 157 Cal. Rptr. at 486.

³³ *Id.* at 818, 598 P.2d at 456, 157 Cal. Rptr. at 486. See note 27 *supra* for a discussion of the implied covenant of good faith and fair dealing as a basis of tort liability in California.

³⁴ 24 Cal. 3d at 819, 598 P.2d at 456, 157 Cal. Rptr. at 486. See text accompanying notes 13, 19 *supra*.

³⁵ 24 Cal. 3d at 819, 598 P.2d at 456, 157 Cal. Rptr. at 486.

³⁶ *Id.* at 824, 598 P.2d at 460, 157 Cal. Rptr. at 490.

California Civil Code which requires that a defendant be guilty of express or implied oppression, fraud or malice before a court may award punitive damages.³⁷ Punitive damages in California effect the vital public policy of deterring socially undesirable acts, such as objectionable corporate policies and practices.³⁸ The court noted that the availability of punitive damages in cases such as *Egan* encourages insurers to observe their fiduciary obligations to the insured.³⁹ After reflecting on the principal purpose for punitive damage awards, the court found that substantial evidence in the record supported the jury's decision to assess punitive damages.⁴⁰

Third, the court disregarded Mutual's defense that it was not liable for the actions of its agents when a plaintiff seeks punitive damages based upon the activities of those agents.⁴¹ The court stated that the critical issue here was the breadth of the em-

³⁷ *Id.*, at 819, 598 P.2d at 456, 157 Cal. Rptr. at 486. CAL. CIV. CODE § 3294 (West 1970) provides:

In an action for the breach of an obligation not arising from contract, where the defendant has been guilty of oppression, fraud or malice, express or implied, the plaintiff, in addition to the actual damages, may recover damages for the sake of example, and by way of punishing the defendant.

³⁸ *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 598 P.2d 452, 457, 157 Cal. Rptr. 482, 488 (1979), *citing* *Ferraro v. Pacific Fin. Corp.* 8 Cal. App. 3d 339, 353, 87 Cal. Rptr. 226 (1st Dist. 1970). *See* note 50 *infra*.

³⁹ *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 820-21, 598 P.2d 452, 457-58, 157 Cal. Rptr. 482, 487-88 (1979). The California Supreme Court stated for the first time in *Egan* that an insurer's obligation toward its insured is fiduciary in nature. CAL. TRIAL LAW A. FORUM, *supra* note 31, at 1,6. This fiduciary relation arises in the case of insurance contracts because the insurer supplies a public service and holds a superior bargaining position in the contractual relationship. 24 Cal. 3d at 820-21, 598 P.2d at 457-58, 157 Cal. Rptr. at 487-88. For discussions of the insurer's fiduciary responsibility to the insured, *see* authorities cited in Justice Mosk's opinion, *id.*

⁴⁰ 24 Cal. 3d at 822, 598 P.2d at 458, 157 Cal. Rptr. at 488. The court stated that from the record the jury might reasonably find that defendant "acted maliciously, with an intent to oppress, and in conscious disregard of the rights of the insured." *Id.* at 822, 598 P.2d at 458, 157 Cal. Rptr. at 488, *citing* *Neal v. Farmers Ins. Exchange*, 21 Cal. 3d 910, 923, 582 P.2d 980, 986-87, 148 Cal. Rptr. 389, 395-96 (1978). Justice Mosk noted that the court was governed by the substantial evidence test set forth in *Crawford v. Southern Pacific Co.*, 3 Cal. 2d 427, 429, 45 P.2d 183, 184 (1935), and by the rule in *Davis v. Hearst*, 160 Ca. 143, 173, 116 P. 530, 543 (1911), that the determination of tort liability is wholly within the control of the jury. *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d at 821, 598 P.2d at 458, 157 Cal. Rptr. at 488.

⁴¹ 24 Cal. 3d at 822, 598 P.2d at 458, 157 Cal. Rptr. at 488.

ployee's power to make corporate policy decisions.⁴² Since Mutual's agents could dispose of claims with little supervision, their actions were really ad hoc policy formulations.⁴³ The court, therefore, found Mutual liable for its agents' actions.⁴⁴

The fourth and final issue addressed in *Egan* concerned the excessiveness of the \$5 million punitive damages award. The court considered each of three previously described factors for determining whether a punitive damage award was excessive as a matter of law.⁴⁵ These factors include the reprehensibility of the defendant's acts, the amount of compensatory damages awarded and the defendant's wealth.⁴⁶ Applying these considerations to the damage award assessed in *Egan*, the court observed that the \$123,600 compensatory damages were substantial, the \$5 million

⁴² *Id.* at 822-23, 598 P.2d at 459, 157 Cal. Rptr. at 489. The court stated that California's interpretation of the RESTATEMENT (SECOND) OF TORTS § 909 (Tent. Draft No. 19, 1979) regarding assessment of punitive damages against a principal for acts of its managerial employees was broader than Mutual asserted it to be. *Id.* The Restatement Rule assesses punitive damages against the principal because of an act by its agent if the agent was (1) employed in a managerial capacity and (2) acting in the scope of employment. RESTATEMENT (SECOND) OF TORTS § 909 (Tent. Draft No. 19, 1979). With respect to the first requirement, the court found that actual power to make corporate policy decisions elevates employees to a managerial status. *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d at 823, 598 P.2d at 459, 157 Cal. Rptr. at 489. This is significant because it requires that their decisions conform to the fiduciary responsibilities of the insurer. To the extent these decisions breach the fiduciary obligation, the insurer may be held liable for compensatory and punitive damages. *Id.* As to the second requirement, since Mutual's agents were vested with such broad discretion in the disposition of an insured's claim, the court found them to be acting within the scope of their authority. *Id.*

⁴³ 24 Cal. 3d at 823, 598 P.2d at 459, 157 Cal. Rptr. at 489.

⁴⁴ *Id.*

⁴⁵ *Id.* The court stated that the factors set forth in *Neal v. Farmers Ins. Exchange*, 21 Cal. 3d 910, 582 P.2d 980, 148 Cal. Rptr. 389 (1978), governed appellate determination of excessiveness.

⁴⁶ *Neal v. Farmers Ins. Exchange*, 21 Cal. 3d 910, 928, 582 P.2d 980, 990, 148 Cal. Rptr. 389, 399 (1978). *Neal* set forth several principles for assessing punitive damages. First, the more reprehensible the act, the greater the appropriate punishment, assuming all other factors are equal. *Id.* Second, punitive damages must be reasonably related to the amount of compensatory damages awarded. *Id.* The court stated that even a considerably reprehensible act will not justify a proportionately high punitive damage award if little actual harm is suffered. *Id.* This note demonstrates that the continued use of the "reasonable relation" test as set forth in *Neal* severely hinders the deterrent purpose of punitive damage awards. See discussion at notes 60-62 and accompanying text *infra*. Third, the court stated that the particular defendant's wealth must be considered to effectively achieve the deterrent and punishment functions. *Id.*

punitive damage award was more than 40 times larger than the compensatory damages and the punitive award represented a considerable portion of Mutual's net income.⁴⁷ The court concluded that the punitive damage award was the result of passion and prejudice by the jurors and, hence, excessive as a matter of law.⁴⁸ The court therefore reversed the award of punitive damages.⁴⁹ This reversal does not comport with the purpose and hinders the effectiveness of punitive damage awards in California.

II. PUNITIVE DAMAGES AND THE EXCESSIVE AWARD

A. *The Law*

The contemporary⁵⁰ purpose of punitive damages is to punish the defendant for certain conduct and deter the defendant and others from similar future conduct.⁵¹ While the jury has discretion to set the amount of punitive damages warranted in a particular case,⁵² courts can review and set aside punitive damage awards they find excessive.⁵³

*Neal v. Farmers Insurance Exchange*⁵⁴ recently set forth the

⁴⁷ *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d at 824, 598 P.2d at 460, 157 Cal. Rptr. at 490. See notes 75-77 and accompanying text *infra*.

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ Historically, punitive damages also served the purposes of revenge and compensation. For concise discussions on the origin and purposes of punitive damages, see Comment, *Punitive Damages and the Reasonable Relation Rule: A Study in Frustration of Purpose*, 9 PAC. L.J. 823 (1978); Owen, *Punitive Damages in Products Liability Litigation*, 74 MICH. L. REV. 1258, 1262-68 (1976); Morris, *Punitive Damages in Tort Cases*, 44 HARV. L. REV. 1173 (1931).

⁵¹ See, CAL. CIV. CODE § 3294 (West 1970); *Gertz v. Robert Welch, Inc.*, 418 U.S. 323, 350 (1974); *Bertero v. National General Corp.*, 13 Cal. 3d 43, 65, 529 P.2d 608, 624, 118 Cal. Rptr. 184, 200 (1974); *Merlo v. Standard Life Ins. Co.*, 59 Cal. App. 3d 5, 18, 130 Cal. Rptr. 416, 425 (1976); *Fletcher v. Western National Life Ins. Co.*, 10 Cal. App. 3d 376, 409, 89 Cal. Rptr. 78, 99 (1970); RESTATEMENT (SECOND) OF TORTS § 908, Comment (a), at 464 (1977); W. PROSSER, HANDBOOK OF THE LAW OF TORTS, § 2, at 9 (4th ed. 1971).

⁵² The decision to award punitive damages, as well as the amount of such damages, is within the jury's province. *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 821, 598 P.2d 452, 458, 157 Cal. Rptr. 482, 488 (1979); *Finney v. Lockhart*, 35 Cal. 2d 161, 163, 217 P.2d 19, 21 (1950); *Davis v. Hearst*, 160 Cal. 143, 173, 116 P. 530, 543 (1911) ("wholly within the control of the jury"); *Russell v. Denison*, 50 Cal. 243 (1875); *Weisenburg v. Molina*, 58 Cal. App. 3d 478, 490, 129 Cal. Rptr. 813, 820 (1976).

⁵³ *Finney v. Lockhart*, 35 Cal. 2d 161, 164, 217 P.2d 19, 21 (1950).

⁵⁴ 21 Cal. 3d 910, 582 P.2d 980, 148 Cal. Rptr. 389 (1978).

California test for assessing whether an award of punitive damages is excessive.⁵⁵ This test, adopted in *Egan*, includes three factors.⁵⁶ The overriding factor limiting punitive damage awards under this test is the so-called "reasonable relation" rule.⁵⁷ Whenever punitive damages are awarded, a reasonable relation must exist between the actual damages suffered and the award of punitive damages.⁵⁸ In the absence of a "reasonable relation," the punitive damage award will be deemed excessive.⁵⁹

The "reasonable relation" rule, however, improperly shifts the focus of punitive damages from defendant's conduct to the actual result of that conduct. The defendant's conduct may in fact be more reprehensible than the actual harm resulting therefrom. Thus, for deterrent purposes, a defendant's conduct may deserve a greater punitive damage award than one computed from the actual harm caused.⁶⁰

The purpose and statutory elements of a punitive damage award emphasize the defendant's conduct.⁶¹ Logically then, puni-

⁵⁵ *Id.* at 928, 582 P.2d at 990, 148 Cal. Rptr. at 399. See note 46 and accompanying text *supra*.

⁵⁶ *Id.*

⁵⁷ The "reasonable relation" rule has been applied in some form throughout California punitive damages law. See *Finney v. Lockhart*, 35 Cal. 2d 161, 164, 217 P.2d 19, 21 (1950); *Russell v. Denison*, 45 Cal. 337, 342 (1873); *Wilkinson v. Singh*, 93 Cal. App. 337, 345, 269 P. 705, 709 (1928); *Plotnik v. Rosenberg*, 55 Cal. App. 408, 410, 203 P. 438, 439 (1921).

⁵⁸ See note 46 and accompanying text *supra*.

⁵⁹ *Id.*

⁶⁰ A simple example illustrates the illogical results reached under the "reasonable relation" test:

The man who has shot into the crowd and broken a pair of eye glasses, probably will kill someone if his act is repeated, and this probability is not lessened because of the comparatively innocuous results of his first shot. The significance of his behavior from the point of view of the general security is that he shot into a crowd, and he and others might shoot into crowds in the future. The destruction of the ten-dollar eye glasses is only important in view of the reparative function as used for the protection of the economic stability of the owner by money substitution.

Morris, *supra* note 50, at 1181. One author, citing *Morris*, suggests that punitive damages be related to the probable result of defendant's conduct, rather than the actual result. Comment, *Egan v. Mutual of Omaha Ins. Co.: The Expanding Use of Punitive Damages in Breach of Insurance Contract Actions*, 15 SAN DIEGO L. REV. 287, 303 (1978). In any event, the "reasonable relation" test as it exists in California fails to adequately achieve the deterrent function of punitive damages. See notes 50 and 51 and accompanying text *supra*.

⁶¹ CAL. CIV. CODE § 3294 (West 1970); see also note 37 *supra*. This should be

tive damage awards should be based solely on the other two factors of the *Neal* test: a defendant's wealth and the reprehensibility of defendant's conduct. Further, courts should assess reprehensibility of conduct independently of actual harm.

These considerations are proper since the purpose of punitive damages is to deter future conduct and its potential result rather than merely punishing for the actual result that defendant's conduct caused.⁶² A trier of fact could then use defendant's wealth to pinpoint the monetary penalty sufficient to deter similar future conduct.⁶³

B. *The Egan Decision*

The *Egan* court's decision to reverse the punitive damage award as excessive was not supported by sound reasoning. The court appeared to rationalize a result it had reached at "first blush,"⁶⁴ and failed to adequately explain why the award was excessive for the purpose of deterrence.⁶⁵

Courts have actually used the reasonable relation rule to rationalize their own upper limit on punitive damage awards.⁶⁶ This application of the reasonable relation rule has resulted in gross inconsistencies as to the proper ratio of punitive to compensatory

distinguished from compensatory damages where the focus is on the plaintiff's injury. See Comment, *supra* note 50, at 827; Morris, *supra* note 50, at 1181.

⁶² See note 60 and accompanying text *supra*.

⁶³ To adequately accomplish deterrence, the same malicious act may allow for different monetary penalties where one defendant is wealthy and the other poor. See Hafif, *Punitive Damages—The Six Standards of Judicial Review or How Much is Too Much?*, 16 CALIF. TRIAL LAW. J. 31, 34-35 (Spring 1977).

⁶⁴ *Huckle v. Money*, 95 Eng. Rep. 768 (K.B. 1763) was the English standard for setting aside punitive damage awards as excessive. Its concept of a "first blush" reaction to an award for determining excessiveness still seems to be vital in California Law. See *Finney v. Lockhart*, 35 Cal. 2d 161, 164, 217 P.2d 19, 217 (1950) wherein the court stated that a damages award may be deemed excessive if the jury was swayed by "passion and prejudice."

⁶⁵ Although the court stated that deterrence of objectionable corporate policies was the purpose of section 3294 under the facts presented in *Egan*, the court did not analyze the amount of punitive damages awarded by the trial court in terms of its deterrent value. *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 820, 824, 598 P.2d 452, 457, 460, 157 Cal. Rptr. 482, 487, 490 (1979).

⁶⁶ Punitive damages awards have generally been allowed only up to a maximum of \$200,000 regardless of the resulting low ratio of punitive to compensatory damages. See Goodman & Seaton, *Foreword: Ripe For Decision, Internal Workings and Current Concerns of the California Supreme Court*, 62 CALIF. L. REV. 309, 350 (1974).

damages.⁶⁷ The result is that, instead of applying a definite review standard, California appellate courts substitute their independent judgment of the proper amount of damages for that of the jury.⁶⁸

In *Egan*, the court began its abbreviated analysis by simply stating that the punitive damages awarded were 40 times larger than the compensatory damages, implying that the ratio is too great.⁶⁹ This unstated implication is unpersuasive for two reasons. First, the ratio is derived from the actual damages plaintiff suffered. Such a derivation fails to logically address the purpose of deterring defendant's reprehensible conduct. It merely serves to further confuse the distinction between deterring future similar conduct and punishing for the actual result of past conduct.⁷⁰ Second, the ratio used fails to provide a definite measure under which future juries could properly award punitive damages.⁷¹

⁶⁷ *Finney v. Lockhart*, 35 Cal. 2d 161, 164-65, 217 P.2d 19, 21 (1950) (award of one dollar in nominal damages, \$2,000 for exemplary damages affirmed); *Wetherbee v. United Insurance Co.*, 265 Cal. App. 2d 921, 71 Cal. Rptr. 764 (1st Dist. 1968), *modified*, 18 Cal. App. 3d 266, 95 Cal. Rptr. 678 (1st Dist. 1971) (award of \$1,050 in compensatory damages, \$500,000 in punitive damages reduced to \$200,000); *Wilkinson v. Singh*, 93 Cal. App. 337, 345, 269 P. 705, 708-09 (1928) (stating that the amount of punitive damages allowed is about 20 times the amount of actual damages proved). Several commentators have noted that punitive damages awards bear no relation to actual damages. See Ghiardi, *The Case Against Punitive Damages*, 8 FORUM 411, 418 (1974); Comment, *supra* note 50, at 843.

⁶⁸ Courts arrive at their verdict of a proper award and then adopt the resulting ratio of punitive to compensatory damages as proper. Morris, *supra* note 50, at 1180; Comment, *supra* note 60, at 302-03.

⁶⁹ *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 824, 598 P.2d 452, 460, 157 Cal. Rptr. 482, 490 (1979). Mutual argued in its opening brief that the award of punitive damages was excessive in terms of "its absolute magnitude, in comparison with other final punitive damages judgments against insurance companies, as it relates to Mutual's net operational income, as a percentage of Mutual's total financial worth, or in relation to the amount of actual damages" Opening Brief at 48-70, *Egan v. Mutual of Omaha Ins. Co.*, 63 Cal. App. 3d 659, 133 Cal. Rptr. 899 (1976). The California Supreme Court did not explain which of these factors were determinative of its finding of excessiveness when viewed with the purpose of deterring future objectionable conduct.

⁷⁰ See note 60 *supra*.

⁷¹ See Goodman & Seaton, *supra* note 66, at 350, wherein the authors state: Decisions by trial judges remitting damages awarded by juries are no less the result of visceral reaction than the juries' original awards. And the law is significantly blank on the standards which the courts should apply in assessing the awards. (The reasonable relation rule) is rendered almost meaningless by (the) concession that no fixed

The second step in the court's analysis was to state that the \$123,600 compensatory award was a "not insubstantial assessment" against Mutual.⁷² The court thus implied that this amount would adequately deter similar future conduct by Mutual and others. The court, however, failed to justify its infringement on the jury's function of determining the proper amount of punitive damages.⁷³ The court appears to substitute its own "sense" of the appropriate punishment for that of the jury instead of applying a definite standard of excessiveness. This approach is inconsistent with the theory that punitive damages are the jury's expression of community outrage at the defendant's conduct. In addition, the court fails to explain why \$123,600 is adequate to deter future conduct by Mutual or other insurance companies.⁷⁴

In *Egan*, the court in part assessed the punitive damage award in relation to defendant's wealth.⁷⁵ The court stated that the punitive award of \$5 million was excessive in relation to defendant's net annual income.⁷⁶ This determination was based, however, on defendant's net income in 1973 and 1974.⁷⁷ From the time of trial to the time of appeal, however, defendant's wealth significantly increased.⁷⁸

ratio exists by which to determine the proper proportion between the two classes of damages.

⁷² *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d at 824, 598 P.2d at 460, 157 Cal. Rptr. at 490.

⁷³ The right to award punitive damages and to fix the amount thereof rests entirely within the discretion of the jury. This proposition has been accepted without exception by the California courts. See note 52 *supra*. See also Goodman & Seaton, *supra* note 66, at 349-50; Comment, *supra* note 50, at 831: "The continued use of a rule that invites courts to substitute their judgment for that of the jury, based upon a standard that negates the intended function of punitive damages must be questioned." For the view that appellate courts simply reduce awards as "too high" when juries do possess adequate standards of monetary review, see Hafif, *Punitive Damages—The Six Standards of Judicial Review or How Much is Too Much?*, 16 CALIF. TRIAL LAW. J. 31 (Spring, 1977). For the view that a jury's assessment of punitive damages is totally unguided, see Ghiardi, *supra* note 67, at 413-14.

⁷⁴ \$123,600 represents less than one day of Mutual's net income for 1973; MOODY'S BAND & FINANCE MANUAL 4098-99 (1979). The court made no attempt to justify the deterrent value of this sum on Mutual's future conduct.

⁷⁵ *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d at 824, 598 P.2d at 460, 157 Cal. Rptr. at 490.

⁷⁶ *Id.*

⁷⁷ The \$5 million represents two and one-half months of Mutual's net income in 1973 and more than seven months of such income in 1974. *Id.*

⁷⁸ Here, trial and the imposition of punishment occurred six years after commission of the tort. It should be noted that, for 1978, Mutual earned \$308,709,000

If deterrence is to have its monetary "sting," courts should not ignore the effects of both inflation and actual changes in defendant's wealth. Deterrence of similar future conduct would be better served by assessing the punitive damage award in light of defendant's wealth at the time of imposition of punishment. Further, the measure of defendant's wealth can act as an effective safeguard against excessive awards. Juries may be readily apprised of the defendant's annual income and net worth.⁷⁹ Through review of such wealth-based awards, appellate courts could then forge an acceptable ratio between wealth and punitive awards. This ratio could then be used, in conjunction with the jury's perception of the reprehensibility of defendant's conduct, to determine whether an award was excessive.

III. PUNITIVE DAMAGES AS TAXABLE INCOME

Courts are reluctant to award substantial punitive damages because to do so would give the plaintiff an unjustified windfall.⁸⁰ The "windfall" theory is predicated on the notion that insufficient social purposes are served by giving the plaintiff a large sum of money in addition to the compensatory damages which have already made him whole.⁸¹ Courts may therefore reduce punitive damage awards to avoid unjust enrichment to the plaintiff without a counterbalancing social benefit.⁸² The "windfall" theory,

in net income. MOODY'S BANK AND FINANCE MANUAL 4098-99 (1979). The \$5 million punitive damage award which the court found excessive thus represents only 1.6% of Mutual's current net income. A damage award should similarly be adjusted where defendant's wealth had significantly decreased by the time of trial. Mutual in fact urged in its opening brief that it is the recent financial picture which is pertinent to determining the amount of a punitive damage award. Opening Brief, *supra* note 69, at 49 n.*.

⁷⁹ Where exemplary damages are sought, evidence is admissible to show the wealth of defendants at the time of trial to enable the jury to determine the amount necessary to punish and deter the particular defendant. *Marriot v. Williams*, 152 Cal. 705, 710, 93 P. 875, 877 (1908).

⁸⁰ Comment, *supra* note 60, at 302-03.

⁸¹ Yorio, *The Taxation of Damages: Tax and Non-Tax Policy Considerations*, 62 CORNELL L. REV. 701, 722-24 (1977). *But cf.* Comment, *supra* note 60, at 302-03 which states that revenge and the incentive to bring suit as private attorneys general justify the award of punitive damages to plaintiff.

⁸² In an effort to divert the windfall to a better social purpose, state legislators recently introduced two bills in the California legislature. These bills would divert a significant portion of any punitive damage award to nonprofit public interest, charitable, or educational organizations whose activities aim at preventing the type of harm which was the basis for the award. S.B. 1060 (1979 Reg. Sess.), introduced by Senator Sieroty (D-Los Angeles), gives the punitive dam-

however, hinders the purpose of punitive damages. That purpose is to deter defendant's socially undesirable conduct.⁸³ If a punitive damage award is properly set by a jury so as to deter defendant's conduct, then reducing the award under the windfall theory will thwart the deterrent purpose of that award.

Assuming that the windfall theory is justifiable and that it was applied in *Egan* in reversing the award, an analysis of contemporary tax laws reveals that the plaintiff may be entitled to receive much less of a windfall than the full award. If these tax considerations had been before the court, it might have been less likely to reverse the award under the windfall theory.⁸⁴

These tax considerations focus on recent Revenue Ruling 75-45.⁸⁵ This ruling states that punitive damages awarded on account of personal injuries are included in the specific statutory exclusion from gross income under I.R.C. section 104(a)(2).⁸⁶ This statutory provision excludes "the amount of any damages re-

ages award to any qualifying organization designated by the judge. It also allows plaintiff's attorney up to 20% of the award upon the court's discretion. This bill has been criticized for having removed all of the plaintiff's monetary incentive for pursuing punitive damages. A.B. 1837 (1979 Reg. Sess.), introduced by Assemblyman Imbrecht (D-Ventura), awards 25% of any punitive award in excess of \$5,000 to one or more qualifying organizations as designated by the plaintiff and then approved by the court. A third bill, S.B. 1012 (1979 Reg. Sess.), introduced by Senator Campbell (R-Whittier), would limit punitive damages to double the amount of compensatory damages and require that liability for such damages be proved beyond a reasonable doubt. S.B. 1012 would thwart the purpose of punitive damages where deterrence, in light of defendant's wealth, requires a greater punishment than double the actual damages. See note 60 and accompanying text *supra*. All three bills have been referred to the Senate and Assembly Judiciary Committees for consideration in this year's session.

⁸³ See notes 50, 51 and accompanying text *supra*.

⁸⁴ Plaintiff-Respondent Egan raised the issue of taxation of punitive damages in his brief. Answer to Petition for Hearing Requested by Mutual of Omaha at 21-22, *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 598 P.2d 452, 157 Cal. Rptr. 482 (1979). Although the conflict between Revenue Ruling 75-45 and *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), see notes 84-95 and accompanying text *infra*, was not addressed, plaintiff did argue that the punitive damages awarded were taxable under *Glenshaw Glass* at the 70% rate for federal taxes and at the 10% rate for California taxes. *Id.* at 21. Plaintiff therefore concluded that rather than receiving a "windfall," plaintiff had brought suit to the monetary benefit of the general public. *Id.* at 22. The California Supreme Court did not address itself in *Egan* to the taxation of punitive damages as a mitigation of plaintiff's "windfall."

⁸⁵ Rev. Rul. 75-45, 1975-1 C.B. 47, superseding Rev. Rul. 58-578, 1978-2 C.B. 38.

⁸⁶ I.R.C. § 104(a)(2).

ceived (whether by suit or agreement) on account of personal injuries or sickness" in an action grounded in tort or tort-type rights.⁸⁷

Revenue Ruling 75-45 is, however, an unsubstantiated interpretation of section 104(a)(2). The ruling conflicts with the United States Supreme Court decision in *Commissioner v. Glenshaw Glass*⁸⁸ that punitive damages are taxable.⁸⁹ *Glenshaw Glass* stands for the proposition that gross income encompasses all "gains or profits and income from any source whatever" unless there is an express statutory exclusion that is applicable.⁹⁰ The Court then stated that punitive damages could not be classified as gifts and do not come under any other exemption in the 1954 I.R.C.⁹¹ Section 104(a)(2) of the 1954 I.R.C. does not expressly exclude punitive damages from gross income.

Section 104(a)(2) states that damages "on account of personal injury or sickness" are excluded.⁹² The Court in *Glenshaw Glass* noted that such compensatory damages for personal injury are exempt on the theory that they represent a restoration of human capital.⁹³ The Court stated that punitive damages could not be

⁸⁷ *Id.*

⁸⁸ 348 U.S. 426 (1955).

⁸⁹ *Id.* at 432-33.

⁹⁰ *Id.* at 429-30. Section 22(a) of the 1939 Internal Revenue Code defines income as including "gains or profits and income derived from any source whatever" The Court in *Glenshaw Glass* noted that this was a very broad taxing power, relying on *Helvering v. Clifford*, 309 U.S. 331, 334 (1940); *Helvering v. Midland Mutual Life Ins. Co.*, 300 U.S. 216, 223 (1931); *Douglas v. Willcuts*, 296 U.S. 1, 9 (1935); *Irwin v. Gavit*, 268 U.S. 161, 166 (1925). *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 429 (1955). The *Glenshaw Glass* court stated that I.R.C. § 61(a) (1954) adopted the broad interpretation of the taxing power set forth in section 22(a) of the 1939 I.R.C. *Id.* at 432 n.9-11. For the proposition that § 22(a) should be interpreted broadly, see *Commissioner v. Jacobson*, 336 U.S. 28, 49 (1949); *Helvering v. Stockholms Enskilda Bank*, 293 U.S. 84, 91-97 (1934).

⁹¹ The Court stated that the 1954 Code's legislative history could not support the proposition that punitive damage awards are nontaxable. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 432 (1955). Section 104(a)(2) was enacted as part of the 1954 I.R.C. The Court therefore expressly disavowed the interpretation of section 104(a)(2) that is set forth in Rev. Rul. 75-45.

⁹² I.R.C. § 104(a)(2).

⁹³ *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 432 n.8 (1955). See also Yorio, *supra* note 81, at 711-12. Nontaxable personal injury recoveries have been called capital assets in the form of the human body or an individual's reputation. See S. 1384, 2 C.B. 71,72 (1920), exempting proceeds of an insurance policy on grounds that the human body is a form of capital.

considered a restoration of capital for taxation purposes.⁹⁴ For taxation purposes, the Court thus found a distinction between damages that serve to compensate the plaintiff and those that serve to punish the defendant. Punitive damages therefore are not received "on account of personal injuries or sickness," but because of and in order to deter the malicious conduct of the defendant. This accords with the California statute on punitive damages which states that their purpose is to punish and deter the defendant.⁹⁵ Thus, Revenue Ruling 75-45 conflicts with the sound reasoning and express finding of the Court in *Glenshaw Glass* that punitive damages are taxable.⁹⁶

In addition, Revenue Ruling 75-45 creates some uncertainty in the type of situation presented in *Egan*. Section 104(a)(2) excludes from taxation those damages received "on account of personal injury or sickness."⁹⁷ By inference, then, damages received on account of something other than "personal injuries or sickness" may be taxable. The *Egan* suit, however, was brought on the basis of a breach of the implied covenant of good faith and fair dealing.⁹⁸ This action is not grounded in the type of personal injury contemplated by section 104(a)(2). Section 104(a)(2) is traditionally interpreted to apply only to "physical" personal injuries.⁹⁹ A breach of the implied covenant of good faith and fair dealing is an action based on a violation of a contractual right.¹⁰⁰ This violation is itself not based on a physical injury, although the claim under the insurance policy may be the result of a physical injury or sickness.¹⁰¹

It can be argued that all damages received for violation of the implied covenant of good faith and fair dealing are not "on account of personal injuries or sickness" and therefore do not fall under the section 104(a)(2) exemption. Such damages would thus be taxable to the plaintiff Egan at a 70% tax rate.¹⁰² His windfall

⁹⁴ *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 432 n.8 (1955).

⁹⁵ CAL. CIV. CODE § 3294 (West 1970). See note 37 *supra* for the full text of § 3294.

⁹⁶ *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 432-33 (1955).

⁹⁷ I.R.C. § 104(a)(2).

⁹⁸ See note 27 and accompanying text *supra*.

⁹⁹ J. FREELAND, S. LIND, & R. STEPHENS, *FUNDAMENTALS OF FEDERAL INCOME TAXATION* 214-15 (2d ed. 1979).

¹⁰⁰ See notes 27, 31 and accompanying text *supra*.

¹⁰¹ The claim under the insurance policy would be exempt under I.R.C. § 104(a)(3).

¹⁰² I.R.C. § 1.

would thus be considerably less than the full award. Courts should therefore be more reluctant to reverse such a taxable award under the windfall theory.

Finally, even if punitive damages were found to be fully exempt from taxation under section 104(a)(2), the entire sum would not go to the plaintiff as a windfall. A portion of the punitive damages would be paid to plaintiff's lawyers as their contingent fee. This portion can vary from twenty-five to forty percent of the punitive damage award.¹⁰³ This contingent fee would, of course, be taxable as part of the lawyer's income.¹⁰⁴ Thus, plaintiff would not receive the full punitive damage award as a windfall.

CONCLUSION

In *Egan v. Mutual of Omaha Insurance Co.*, the California Supreme Court applied a standard of review for a punitive damage award that both usurped proper jury function and bore no relation to the deterrent purpose of punitive damages. In reaffirming the "reasonable relation" rule's vitality, the court has encouraged appellate courts to substitute their view of a proper award for that of the jury. The "reasonable relation" rule also bears no correlation to deterrence of the defendant's conduct. To the extent that wealth is used as the measure of an appropriate award, jury instructions and evidence of defendant's wealth at trial will provide a manageable standard for setting and reviewing awards, thus leaving to the jury its expression of community outrage at reprehensible conduct. In addition, the court's possible reluctance to issue plaintiff a "windfall" should be lessened by a reversal of the recent revenue ruling exempting from taxation punitive damages based on injury or sickness.

Michael Evan Kramer

¹⁰³ J. O'CONNELL, *THE INJURY INDUSTRY* 37-38 (1971).

¹⁰⁴ I.R.C. § 61(a).