

## STATE COURT INCREASES DAMAGES FOR HARASSMENT AND DISCRIMINATION CASES

By Karen Sutherland

### LEGAL BACKGROUND

Prior to the end of last year, employers who were sued for discrimination or harassment under Washington's Laws Against Discrimination, RCW Ch. 49.60 ("WLAD"), were liable for damages such as lost wages (past and future), medical expenses (such as expenses for counseling), job search expenses, emotional distress, prejudgment interest, and attorney's fees and costs. In a decision issued late last year, Blaney v. Ass'n of Workers, 114 Wn. App. 80 (2002), the Washington State Court of Appeals expanded the categories of damages to include an award to compensate the employee for taxes on the other damages that the employee receives. This new decision is important not only for case decisions, but also for placing a settlement value on the employee's claims.

By way of background, when people receive awards for personal injuries or sickness, the awards generally are not taxable under IRC § 104. Attorneys used to apply this concept to settlements of employment disputes on the theory that the emotional distress and its physical manifestations (loss of sleep, loss of consortium, depression, irritability, stomach disorders, etc.) were nontaxable personal injuries.

Effective August 1996, Congress amended IRC § 104 so that emotional distress is not considered a physical injury or physical sickness even if such physical symptoms as insomnia, headaches and stomach disorders result from such emotional distress. This amendment to IRC § 104 makes it highly unlikely that an employment discrimination settlement or award can be allocated to avoid taxation. As a result, the award or settlement is taxable and subject to withholding for income tax and FICA, even if the employee is no longer employed by the employer under IRC § 3402(a)(1); Reg. § 31.3401(a)-1; IRC § 3102; Reg. § 31.3121(a)-1(i).

As a result of the change in the tax code, the additional lump sum income may put the employee in a higher tax bracket, and in the Blaney case, the employee was subject to alternative minimum tax because of the effect of the IRS Code on the payment of attorney's fees awarded to her.

Under the analysis in the Blaney decision, the effect of the taxability of harassment and discrimination damages has been to leave the employee with a net award that can be substantially less than what the judge or jury intended, and that, as a result, does not make the employee whole. The Blaney court referred to a case where a Chicago police officer won a sex discrimination and harassment award of \$300,000 and an award of attorney's fees and costs of almost \$1 million. According to her lawyer, her taxes obligation made it so that she did not receive any of the damages awarded to her and ended up owing the IRS \$99,000.

In the Blaney case, the jury awarded the employee \$638,764 in damages, and the judge then awarded \$235,625.38 for prejudgment interest, attorney and expert witness fees, and costs. A certified public accountant testified that the employee would have to pay an extra \$244,753 in taxes as a result of winning her case against her employer.

The employer argued that the tax consequences of the award were not “actual damages,” but the Court of Appeals disagreed in light of the broad language of the statute and its purpose, which is to “deter and eradicate discrimination.” The Blaney court did not clearly address the fact that the plaintiff would have had to pay taxes on her earnings from her employer if she had been paid them in the normal course of her employment, instead of having them awarded to her as damages in a lawsuit. The court declined to decide whether adverse tax consequences arising from damages awards and/or attorney’s fees in cases other than those arising under the WLAD could serve as a basis for damages, but the court did leave open that possibility.

### **PRACTICAL GUIDELINES**

- The Blaney decision, in effect, raises the settlement value of discrimination and harassment cases under state law by the amount of taxes, for example, in the Blaney decision, by 28%. The actual amount will vary, depending on the employee’s tax situation. As a result, preventive measures and early settlement in established cases becomes increasingly important because the claims are now worth more than they were before.
- If you have employee practices liability coverage, check your insurance to see if it will cover an award of taxes. Check with your broker (and get the broker’s response in writing) if you are not sure.
- Be aware that the costs and complexity of trying a harassment or discrimination case under state law will increase because of the need for testimony regarding the tax effects of any award.
- Though the Blaney court did not address the issue, under its reasoning, the supplemental award to cover taxes would need to be grossed up to take into account the effects of taxing the supplemental award. In other words, if Ms. Blaney was awarded \$244,753 for her tax obligation, that award also would be taxable and, under the court’s reasoning, should be grossed up as well.
- So far, there have been no reported decisions interpreting the Blaney decision or seeking to apply it in other contexts. A similar result could be reached in other civil cases based on a statute with a remedial purpose, such as the Wage and Hour Laws, the Consumer Protection Act, or other statutes.

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*The above suggestions are broad, general comments only, and are not legal advice, nor do they create an attorney-client relationship. Individual situations require individual analysis. For assistance with a specific situation, contact an attorney with experience in this area, such Karen Sutherland, Chair of the Employment and Labor Law Practice Group of Ogden Murphy Wallace, P.L.L.C. Karen Sutherland can be reached at (206) 447-7000 or by e-mail at [ksutherland@omwlaw.com](mailto:ksutherland@omwlaw.com).*