Nebraska and Punitive Damages: Transaction Costs

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ABSTRACT:

Compensatory damages are a cash payment calibrated to make the injured party legally whole: both for a tort and for a breach of contract. In stark contrast, punitive damages (a.k.a., exemplary damages) are an additional transaction cost intended to alter the defendant's profit calculus. BATNA and decision trees are negotiation tolls to clarify the parties' options when applying that profit calculus. Especially reprehensible breaches of a duty support the judicial award of constitutionally permissible punitive damages. By judicial interpretation of constitutional limits on the amount of a punitive damages award it is limited to an amount no more than ten times compensatory damages. Punitive damages are available for all torts but only are available for bad faith breaches of two types of contracts: contracts of insurance and contacts of employment. Most jurisdictions award the plaintiff the punitive damages *ala* a finder's fee. Nebraska, by its constitution, allocates punitive damages to K12 education. Thus, Nebraska puts an unusual transaction cost spin on a defendant's profit calculus. In 2019 Senator Wayne introduced LB419 addressing some of those transaction cost allocations.

INTRODUCTION

All well-trained negotiators have as a high priority goal of helping their opposite to better perceive each party's BATNA[2]. Well-trained negotiators seeking an agreement additionally have as one high priority goal the raising their opposite's perception of that opposite's own BATNA as well as lowering that opposite's perception of your BATNA. One's perception of each party's BATNA is critical to reaching an agreement. The relative positioning of the parties' BATNAs must create an area of overlap, or Zone of Agreement (ZOA), if the parties are to reach an agreement. That is, if one party perceives their own BATNA as inferior to an agreement, then that party will seek out the path either to an agreement or to an improved BATNA. But only if both parties perceive their own BATNA as inferior to the proposed agreement will they both voluntarily accept that agreement.

This paper is about raising the wrong doer's BATNA (read: make agreement superior to resorting to the BATNA) prior to wrongful action as well as improving the wrong doer's

[2] BATNA is the **B**est **A**lternative **T**o a **N**egotiated **A**greement. See, *Getting to YES!* by Fischer and Ury, any of the tens of editions.

perception of their own BATNA as an increasing (i.e., worsening) BATNA after wrongful action. In economics speak, it is about transaction costs and one's profit calculus.

Punitive damages are subject both to limits imposed by the USA *Constitution* as well as limits imposed by each USA State's *Constitution*. The USA federal *Constitution* has an implied separation of powers (i.e., legislative, executive, and judicial in the structure of the opening Articles I, II, and III) as well as a requirement of due process of law,[3] both in Amendment V and in Amendment XIV. The USA Supreme Court has interpreted these interacting provisions as creating a due process limitation on judicially imposed punitive damages. While the judiciary has an inherent power to award punitive damages, given that implied separation of power, it is feasible that judicial action might stray into the realm of an exclusive legislative power to define and punish crimes. Accordingly, judicially imposed punitive damages have three due process limitations.

To satisfy substantive due process and procedural due process requirements, punitive damages are to be calibrated by:

[i] the degree of reprehensibility of the defendant's conduct (i.e., a procedural due process limitation on the courts);

[ii] a reasonable ratio between punitive and compensatory damages; with a maximum ratio of 10:1 (i.e., a substantive due process limitation recognizing the separation of powers between the legislative and the judicial branches); and

[iii] a proportionality of punitive damages to any legislatively specified fines for similar behavior (i.e., a legislatively controlled procedural due process limitation on the courts).

A common example of constraint [iii] is the legislative imposition of automatic treble (i.e., times three) damages for antitrust violations.

For the purposes of this paper all USA *Constitution* requirements will be assumed to have been satisfied.

All jurisdictions limit the range of defendant behaviors for which a plaintiff may obtain punitive damages. Generally, all torts are eligible if the defendant's behavior is sufficiently reprehensible. Generally, breaches of contract are not eligible for punitive damages regardless of

[3] https://www.archives.gov/founding-docs/constitution

how reprehensible the defendant's behavior: except for employment contracts and for insurance contracts.

Why are bad faith breaches of employment contacts and of insurance contracts eligible for an award of punitive damages?

Employment relationships do not have to be (but may be) contracts, and when not a contract are eligible via tort law for punitive damages. Public policy would be inappropriately distorted if contractual emploment relationships were not eligible for punitive damages and non-contract employment relationships were eligible for punitive damages. As for insurance contracts, the essence of contractual compensatory damages is to empower the wronged plaintiff to enter the market and to obtain substitute performance. But, upon the occurrence of an insured loss followed by the insurer's bad faith breach, there is no market for substitute performance (that would be the epitome of adverse selection). Similarly, employment contracts often are viewed as "personal" services contracts for which, as a matter of law, no substitute exists in the market. Similarly, employment contracts involve a non-fungible (in economics speak, non-homogenous) subject matter which materially limits the wronged party's ability to obtain substitute performance from the market post-breach.

Generally, punitive damages are awarded to the plaintiff who did suffer the defendant's especially reprehensible, wrongful behavior. Nebraska is odd in how it handles punitive damages.

The vast majority of jurisdictions allow punitive damages in some form. Most of those jurisdictions structure the award of punitive damages in the fashion of a finder's fee. That is, either one member of a class, or the class[4] suing in all of their names, suffering the wrong doer's especially reprehensible action(s) in addition to their routinely recoverable compensatory damages is/are awarded punitive damages. Also note, Nebraska, by its *Constitution*,[5] awards

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[4] Another oddity of Nebraska law ought to be noted at this juncture. Unlike most other jurisdictions (which welcome class action law suits as a mechanism for judicial efficiency and as a mechanism for addressing specific forms of abusive behavior by wrong doers), Nebraska has such stringent requirements for class certification that when suing under State law it is theoretically feasible to file as a class but it is practically impossible to obtain class certification. Unlike other jurisdictions, in Nebraska to obtain judicial certification of a class action suit the aggregated plaintiff's much petition for identical redress for identical harms. Identical is quite rare in the real world. Accordingly, punitive damages, in reality, solely are embedded in an individual's law suit.

[5] The whole of Nebraska *Constitution*, Article VII, section 5 is quoted below. For our purposes only subsection (1) is on point.

"**VII-5.**

Fines, penalties, and license money; allocation; use of forfeited conveyances.

those punitive damages to the whole of society via placing those damages into an income-only endowment for free public K12 education.

This paper is timely both because litigators representing parties injured by especially reprehensible wrong doers always are in need of mechanisms for achieving full redress as well as at the start of the Nebraska Legislature's 2019 term Senator Justin Wayne[6] has introduced LB 491 (2019) on punitive damages.[7]

COMPENSATORY NECESSARILY IS LESS THAN FULL RECOVERY

All jurisdictions award successful plaintiffs compensatory damages. Jurisdictions vary widely as to which losses are recoverable as compensatory damages. For example, California welcomes claims of mental injury while Nebraska is far less welcoming. But, all jurisdictions define some losses as beyond permissible recovery as compensatory damages.

Additionally, most USA jurisdictions in most litigation contexts require both parties to pay all of their own attorney fees and other litigation costs (e.g., expert fees). For example, routinely, a successful plaintiff might suffer total losses of $1.00 but only $0.90 is recoverable as compensatory damages; and, to make that recovery the plaintiff must incur litigation expenses of $0.30. In which case, a successful suit initiated because of a $1.00 loss only nets the plaintiff

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(1) Except as provided in subsections (2) and (3) of this section, all fines, penalties, and license money arising under the general laws of the state, except fines and penalties for violation of laws prohibiting the overloading of vehicles used upon the public roads and highways of this state, shall belong and be paid over to the counties respectively where the same may be levied or imposed, and all fines, penalties, and license money arising under the rules, bylaws, or ordinances of cities, villages, precincts, or other municipal subdivision less than a county shall belong and be paid over to the same respectively. All such fines, penalties, and license money shall be appropriated exclusively to the use and support of the common schools in the respective subdivisions where the same may accrue, except that all fines and penalties for violation of laws prohibiting the overloading of vehicles used upon the public roads and highways shall be placed as follows: Seventy-five per cent in a fund for state highways and twenty-five per cent to the county general fund where the fine or penalty is paid.

(2) Fifty per cent of all money forfeited or seized pursuant to enforcement of the drug laws shall belong and be paid over to the counties for drug enforcement purposes as the Legislature may provide.

(3) Law enforcement agencies may use conveyances forfeited pursuant to enforcement of the drug laws as the Legislature may provide. Upon the sale of such conveyances, the proceeds shall be appropriated exclusively to the use and support of the common schools as provided in subsection (1) of this section."

[6] http://news.legislature.ne.gov/dist13/
Senator Wayne represents District 13 in northeast Omaha, elected to a four-year term in 2016. Nebraska Senators are term limited to two consecutive four-year terms at a time (i.e., may sit out a term and then return).

[7] https://nebraskalegislature.gov/bills/view_bill.php?DocumentID=37709
This link will provide both a copy of the LB 491 (2019) as well as a full updating of the legislative action on this bill. As of the October 2019 NEBA conference, LB 491 (2019) had a public hearing and no additional legislative action.

$0.60 because the plaintiff must first not recover that which is not "compensatory" and second must incur the transaction costs of litigation expenses. Well, nets $0.60 assuming no taxes on that $0.90. And sometimes all of the $0.90 is taxed as current income; feasibly yielding a post-tax net recovery less than zero. For the defendant who is judicially proven to have caused a $0.90 compensable loss suffered by the plaintiff might only pay the plaintiff $0.90 but also the defendant incurs the defense litigation expenses of $0.30; for a defendant's total loss of $1.20. And, of course, the not proven liable defendant still incurs the litigation expense of $0.30. Accordingly, an innocent defendant who "looks" bad might seek to negotiate a settlement so as avoid that potential $1.2o expense by settling for less than the litigation expense of $0.30.[8]

Clearly, litigation transaction costs will influence the plaintiff's BATNA as well as the defendant's BATNA. Typically, a plaintiff who forecasts netting less than zero from litigation will not initiate a law suit. Similarly, a defendant who forecasts litigation expenses in excess of settlement expenses will seek a settlement to end litigation. This BATNAs at work and shaping the Zone of Agreement.

Partly to alter the parties' BATNAs, all USA jurisdictions' legislatures have altered the generic USA judicial rule that each party pays their own litigation expenses: but only in some litigation contexts. Routinely, a defendant found liable for punitive damages either will encounter a statutorily imposed obligation for the plaintiff's attorney fees and/or litigation expenses or will encounter judicial imposition of a defendant's obligation to pay some or all of the plaintiff's litigation expenses.

NEBRASKA'S WAY FOR PUNITIVE DAMAGES

As noted above, Nebraska minimizes class action law suits and pays the punitive damages to the K12 school fund, not to the suing plaintiff. Clearly, the interplay of these two rules will not maximize the frequency of pleadings of colorable claims for punitive damages, nor the frequency of awards for punitive damages, nor the magnitude of total awards for punitive damages, nor maximize sufficiently reprehensible defendant's obligations for plaintiff's litigation expenses. This interplay has a predictable impact on the BATNA of the plaintiff and the

[8] Some plaintiff engage in "greenmail". A plaintiff might sue an innocent defendant who "looks" bad merely to quickly elicit a settlement.

BATNA of the defendant in the context of a colorable claim for punitive damages. Both BATNAs move to create a much narrower Zone of Agreement (ZOA). This interplay is especially important once the parties start adjusting their pre-trial negotiation Bayesian decision trees[9] in light of the various probability density functions of the alternative outcomes.

A Bayesian decision tree has a base on the left, a base that branches out to the right. Each branch is scenario. Each scenario has at least two, but can have multiple, options (i.e., twigs). Each scenario contains its own local BATNA. Each scenario's option has an estimated probability of occurrence that is multiplied times the estimated dollar value of that occurrence; yielding a forecasted value of that occurrence and, by summation, that entire scenario. Across all of the scenarios the tree has a global BATNA. As the parties move from the far right (e.g., ought I file a law suit) towards the left (e.g., dispute is "resolved") branches are trimmed and the tree's global BATNA might rise or fall depending upon which branches' BATNAs have been trimmed.

Generally, in Nebraska, the punitive damages scenario rarely is forecasted with a high probability. This paper argues that predictable impact is not a necessary impact. This paper argues that an appropriately plead claim would not be dismissed and that the plaintiff can improve the plaintiff's forecasted recovery by lowering (i.e., improving) the plaintiff's BATNA and by raising (i.e., worsening) the defendant's BATNA; thus expanding the feasible ZOA.

There is a long line of Nebraska cases where plaintiff litigators with colorable claims for punitive damages were thwarted by poorly drafted pleading. These pleadings were rejected by the appellate courts in carefully crafted opinions. Those litigators asked for punitive damages awards to be delivered to their plaintiffs. The courts carefully rejected those requests for punitive damages noting Nebraska plaintiffs were not eligible recipients punitive damage awards. The phrase "carefully crafted" is used because those opinions do not assert either that punitive damages never are permissible nor assert no one has standing to sue for such damages. Instead, those opinions clearly state the plaintiff suffering a tort or bad faith breach of an employment or insurance contract lacked standing to sue for punitive damages to be paid to the plaintiff. The opinions then do not point to who does have standing; but, also consistently note the provision in the Nebraska *Constitution* awarding punitive damages to the free public K12 schools.

[9] https://en.wikipedia.org/wiki/Bayes%27_theorem

Why would a plaintiff incur the expenses associated with litigating a colorable punitive damages claim when any award will be paid "exclusively to the use and support of the common schools"? There are multiple feasible reasons, but most closely associated with transaction cost analysis is that the plaintiff would seek a punitive damages claim to increase the defendant's BATNA (i.e., reduce the attractiveness of a litigated outcome and increase the attractiveness of an agreement); and to decrease the plaintiff's BATNA (i.e., to reduce the pressure on the plaintiff to accept a defendant's settlement offer). Changing the parties' BATNAs in this way increases both the likelihood of as well as the likely magnitude of a settlement that more fully covers the plaintiff's losses as well as alters the profit calculus of similarly situated defendants.

Few defendant's have engaged in behavior that supports a colorable claim for punitive damages. This paper's analysis is limited to those defendant's whose wrong doing is sufficiently reprehensible.

This paper takes as given that bluffing is an accepted tool of negotiation. To be a useful tool a bluff must be credible. To be credible a suit for punitive damages must make a colorable claim. Non-credible bluffs tend to generate the opposite of the desired result of a credible bluff.

Both the facts at hand as well as the skill of the litigator influence whether a suit for punitive damages is credible. Often the credibility of a pleading is directly dependent upon the credibility of the litigator making the pleading. That is, a litigator who reserves making a claim for punitive damages to only when the claim clearly is colorable, that litigator both gains credibility individually and imbues each claim with credibility. Similarly, a cause of action which is promptly dismissed by the trial judge for the plaintiff's failure to meet the pleading minimums of that jurisdiction for that suit is not a credible: either itself or as a bluff; or for the filing litigator. Yes, avoidance of dismissal merely requires raising material questions of fact; but, a plaintiff seeking punitive damage must offer up more than merely alleging reprehensible wrong doing.

Thus, this paper does not argue for nor encourage litigators zealously representing clients without a colorable claim for punitive damages to make such a claim: quite the opposite. So, we start with a defendant whose wrongful behavior is sufficiently reprehensible (a jurisdiction specific determination) that a colorable claim for punitive damages clearly is present.

If we assume the plaintiff must incur all litigation expenses for the punitive damages claim as well as not reap any reimbursement in any manner from that punitive damages claim

(regardless of its success), then common wisdom asserts no rational litigator would make such a claim. That is the standard set of assumptions. This paper argues both assumption are wrong.

The plaintiff might or might not need to initiate the punitive damages claim as part and parcel of the plaintiff's suit. Most likely the plaintiff must initiate the claim, less frequently the plaintiff will need to sustain action on the claim.

There are (at least) two parties typically thought of as independent of the plaintiff's suit but which, because of a punitive damages claim, clearly are interested in that claim. If the plaintiff's suit and claim are successful, then both the local school board and that schools board's teachers' union will experience an inflow of cash. Accordingly, a plaintiff with clearly colorable claim for punitive damages ought to seek out these potential allies early in the litigation process. Ideally, both or one of these two potential allies would take up the litigation expenses related to punitive damages prior to the filing of the plaintiff's suit. If the plaintiff engages in successful collaboration with other interested parties, then the plaintiff's litigation expenses for punitive damages could be materially reduced to the collaboration efforts rather than directly covering attorney fees and litigation costs.

Senator Wayne's LB 419 (2019) addresses the above problem by legislatively commanding the county attorney to take up the punitive damages suit.

The wronged plaintiff has additional gains (and the defendant additional costs) from the above type collaboration between a plaintiff seeking compensatory damages and a friend of the court seeking the punitive damages for the public schools fund. Most suits are public in name only. Most suits do not become part of a broader public discussion. Initiating collaboration efforts, especially with a publicly elected body and with a large segment of a community's opinion leaders,[10] will raise the visibility of the plaintiff's suit and claims. Rarely does a defendant desire additional publicity about a clearly colorable claim of wrong doing sufficiently reprehensible to warrant an award of punitive damages. This suggests the plaintiff's litigator ought to first surface the potential of a punitive damages claim prior to initiating collaboration efforts since the plaintiff thus can offer the promptly settling defendant a decision tree with the

[10] Most litigation tactics require use of a double-edged sword, and this in no exception. Teachers and other employees from the to-be-benefited school district will be subject to for-cause removal from the jury pool. Necessarily this must reduce the probability of selecting jury that can handle complex transactions as well as reduce the probability of selecting a jury with a preference skewed towards favoring the schools. Both of which are likely to work against the plaintiff's sufficiently reprehensible claim and awarding punitive damages to the schools.

benefit of less publicity; and offer to the dawdling defendant a decision tree with the unmistakable cost of increasing negative publicity.

Both school boards and teachers' unions are likely to be skeptical about joining the plaintiff's suit on the side of punitive damages. Especially so when the litigator is the first litigator to approach any school board or any teachers' union with this opportunity and/or prior to the filing of the suit and prior to the initial round of motions to dismiss. When those related parties are approached very early in the decision tree there are so many feasible outcomes lacking favorable attributes that school boards and teachers' unions are likely to wait until after the initial branches in the decision tree with failure options already have been trimmed by the plaintiff's attorney. But, after dismissal is not obtained by the defendant, these related parties will see more clearly their potential benefits.

Note especially the effect of the litigator's reputation. After a litigator has successfully plead and argued more than one punitive damages claim, and obtained reimbursement for related litigation expenses, the reticence of these related parties likely will evaporate.

If these related parties do not take up the task of litigating the punitive damages claim, then that duty still rests with the plaintiff's litigator. That is, the plaintiff's litigator as the sole litigator on the plaintiff's side will be (somewhat) free to trade with the defendant a larger compensatory damages award in exchange for a finding of zero punitive damages liability.

It is contrary to public policy in nearly all jurisdictions for an insured person to obtain insurance coverage for punitive damage awards. Accordingly, routinely a defendant will have insurance against liability for compensatory damage awards and no insurance coverage for punitive damage awards. Thus, the vast majority of defendants will welcome the opportunity to trade an increased compensatory award for a zero punitive damage award.

Also note, there is both a public relations gain for the defendant and litigation credibility gain for the defendant when the defendant is not "successfully" sued for punitive damages. The reputation of the plaintiff's litigator will be enhanced among the more sophisticated observers of the transaction.

After the litigator has won more than one punitive damage award and has negotiated away at least one potential award, it is likely that the local school boards and teachers' unions will have a change in attitude towards early commitments to assuming the litigation expenses of the punitive damages claim.

CONCLUSION

It is the supposition of the author that too few worthy punitive damage claims are made in Nebraska courts. The BATNA and decision tree analysis of this paper supports the belief that that paucity can be corrected by strategic filing and strategic alliances among the interested parties. If the legislature chooses to adopt Senator Wayne's LB419, then that would be helpful.