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TREBLE DAMAGES IN NATIONAL HEALTH SERVICE CORPS CONTRACTS, PUBLIC POLICY, AND *HAWRONSKY* V. *COMMISSIONER*

*Richard C. E. Beck**

I. INTRODUCTION

This is the second of two articles concerning the deductibility of treble damages for breach of the service agreement in a National Health Service Corps (“NHSC”) scholarship contract. The first article¹ concerned the decision in *Stroud v. United States*.² There the District Court for the District of South Carolina erroneously denied a deduction for the treble damages on the theory that because the tuition and living stipend had been tax-exempt, the damages were expenses “allocable to” tax-exempt income within the meaning of I.R.C. § 265(a)(1).³ As shown at some length in that article, however, I.R.C. § 265(a)(1) does not apply because the treble damages are not incurred in order to obtain a tax-free scholarship, which had already been received many years earlier, but rather to buy out the NHSC service obligation in order to practice medicine elsewhere.⁴

Oddly enough, in the very same year that *Stroud* was decided, the Tax Court also mistakenly denied a deduction for exactly the same NHSC triple damages in *Hawronsky v. Commissioner*,⁵ but on an entirely different and completely unrelated theory, namely that the

* Professor of Law, New York Law School. My thanks to Professor Jacob Todres, to Robert Wood, Esq., to my research assistant Karen Cross, and to my former student Frank Langella, who all made helpful suggestions. Thanks also to New York Law School for its generous support.

1. See Richard C. E. Beck, *Deductibility of Treble Damages Paid for Breach of National Health Service Corps Scholarship Contracts: The Misuse of I.R.C. § 265(a)(1) in Stroud v. United States and of the Origin of the Claim Test in Keane v. Commissioner*, 1 CHARLESTON L. REV. 1 (2006).

2. 906 F. Supp. 990 (D.S.C. 1995), *vacated on other grounds by* 94 F.3d 642 (4th Cir. 1996).

3. *Id.* at 995-96.

4. See Beck, *supra* note 1, at 22-24.

5. 105 T.C. 94 (1995), *aff'd*, 98 F.3d 1338 (5th Cir. 1996).

damages constitute a “fine or similar payment to a government for the violation of any law” within the meaning of I.R.C. § 162(f).⁶ Three years later, yet a third unrelated and erroneous theory was invoked to deny a deduction for interest paid on the same damages in *Keane v. Commissioner*,⁷ a 1998 Tax Court Memorandum Decision, which failed to mention either *Hawronsky* or *Stroud*. None of these decisions has been questioned in the tax literature, and *Hawronsky* and *Stroud* are both cited in many reference works as if they were sound.⁸

The deduction in question was for statutorily prescribed liquidated damages paid by physicians whose medical education had been paid for by the National Health Services Corps (“NHSC”) in exchange for a contractual obligation to practice medicine in an underserved area designated by the NHSC.⁹ NHSC scholarships provide both tuition and fees for health care training, and also a monthly stipend for living expenses.¹⁰ The service obligation may be satisfied by working directly for a governmental agency, or by working in a private clinic, or even by independent private practice, provided the location is approved in advance by the NHSC.¹¹ Physicians who default on their service obligation are required by the contract to pay statutory damages of triple the amount expended by the government for the scholarship plus triple an amount of deemed interest calculated according to a fixed formula in the contract.¹²

6. *Id.* at 101.

7. 75 T.C.M. (CCH) 2046 (1998).

8. *E.g.*, BORIS I. BITTKER, MARTIN J. MCMAHON, JR. & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 11.04[2] n.121 (2d ed., RIA 2006).

9. 42 U.S.C. § 254o(b)(1)(A) (2006).

10. *See* Lora C. Siegler, Annotation, *Validity and Construction of Provisions of National Health Service Corps Scholarship Program*, 108 A.L.R. FED. 313, 320 (1992).

11. *Id.*

12. *See* 42 U.S.C. § 254o(b). According to 42 U.S.C. § 254o(b)(1)(A), the treble damages are formulated using $A = 3 [\text{phi}] (T - S/T)$, where

“A” is the amount the United States is entitled to recover, “ [phi] ” is the sum of the amounts paid under this subpart to or on behalf of the individual and the interest on such amounts which would be payable if at the time the amounts were paid they were loans bearing interest at the maximum legal prevailing rate, as determined by the Treasurer of the United States; “T” is the total number of months in the individual’s period of obligated service; and “S” is the number of months of such period served by him in accordance with section 338C [42 U.S.C. § 254m] or a written agreement under section 338D [42 U.S.C. § 254n].

42 U.S.C. § 254o(b)(1)(A). Such damages are due if the participant fails to begin or to complete his service obligation “for any reason,” which is mitigated only by 42 § U.S.C. 254o(d)(2), according to which the obligation of service or treble damages may be waived pursuant to regulations delegated to the NHSC only if “compliance by the individual is impossible or would involve extreme hardship to the individual and if enforcement of such obligation with respect to any individual would be

The first version of the statute, which was in effect from 1972 until 1977 required only single damages, that is, a return of the government's money plus deemed interest, as many similar State programs still do. The single-damages version was repealed in 1976 and replaced by the current triple-damage provision in 1977.¹³ The purpose of the new provision was apparently to provide the NHSC with a stiff penalty to enforce the service obligation, and the NHSC has often used the threat of treble damages to coerce compliance.¹⁴

According to 42 USC § 254o(b)(1)(A), the treble damages are due if the participant fails to begin or to complete his service obligation "for any reason," which is mitigated only by 42 § USC 254o(d)(2), according to which the obligation of service or treble damages may be waived pursuant to regulations delegated to the HHS only if "compliance by the individual is impossible or would involve extreme hardship to the individual and if enforcement of such obligation with respect to such individual would be unconscionable."

The federal courts have decided more than three dozen reported cases over the question whether the outsized treble-damages provision of the statutory contract is enforceable.¹⁵ All but one of the physicians who resisted payment lost.¹⁶ The reported decisions almost always arise because of disputes growing out of the system by which the NHSC assigns participants to locations for their tours of service.¹⁷ The assignment process is left entirely to the discretion of the NHSC,¹⁸ which consults with state and local authorities and decides which

unconscionable."

13. Siegler, *supra* note 10, at 320 n.2.

14. Donald Lohman, Comment, *The Final Frustration of Defaulting NHSC Scholars?: United States v. Hatcher*, 19 J.C. & U.L. 385, 385 (1993); see also ExpectMore.gov: National Health Service Corps, <http://www.whitehouse.gov/OMB/expectmore/detail.10000278.2005.html> (last visited Feb. 4, 2006).

15. See generally Siegler, *supra* note 10.

16. Seigler, *supra* note 10, at 28 (citing Rendleman v. Sullivan, 760 F. Supp. 842 (D. Or. 1991)). Rendleman lost his appeal, but won in practice because the District court kept remanding his case to the NHSC for reconsideration until the NHSC finally got the point. See Beck, *supra* note 1, at 1.B.1.

17. There is considerable friction between participants and the NHSC. See Kristine Marietti Byrnes, *Is There a Primary Care Doctor in the House? The Legislation Needed to Address a National Shortage*, 25 RUTGERS L.J. 799, and sources cited therein. A 1990 study reported that 13% of participants had failed to do their service obligations and paid damages instead. *Id.* at 813 n.68 (citing 1990 H.R. REP. NO. 642, at 15 (1990), reprinted in 1990 U.S.C.C.A.N. 4289, 4289). Another 1992 study reported considerable unhappiness among participants, many of whom felt they were treated like "indentured servants." *Id.* at 814 n.71 (citing Donald E. Pathman et al., *The Comparative Retention of National Health Service Corps and Other Rural Physicians*, 268 J. AM. MED. ASS'N 1552, 1553-54 (1992)).

18. 42 U.S.C. § 254l(f)(1)(B)(iv).

locations qualify for status as Health Professional Shortage Areas (HPSA). Then the NHSC draws up an annual list of available locations and categorizes them by priority. This is the Health Professional Opportunity List (“HPOL”). Only sites on the HPOL qualify for fulfillment of the service obligation. Participants may apply to serve at any site on the HPOL. The earlier participants apply, the more choice they have. Also, they can virtually assure their first choice if they choose the highest priority (i.e. least desirable) locations. If a participant has not matched to a location by a certain time, the NHSC will assign him to any location it chooses. And if the NHSC declares a participant to be in default for not following its regulations,¹⁹ the NHSC will always forbear to enforce the treble damages obligation if the participant promises again to serve and signs a “forbearance agreement” confessing default and his obligation to pay. But these participants have no choice and must serve wherever the NHSC orders them, and so they often default again until eventually they are forced to pay.²⁰ The tax question is whether the treble damages are deductible.

The main thesis of this article is that *Hawronsky* is erroneous and the deduction should be allowed because I.R.C. § 162(f) does not apply. The taxpayer did pay a “fine or similar penalty to the government,” but he did not pay it “for the violation of any law,” which is a necessary element of I.R.C. § 162(f). The taxpayer merely breached his NHSC contract. This crucial issue went completely unnoticed by the court and the parties. Because I.R.C. § 162(f) does not apply, the treble damages are (except for the original tax-free scholarship itself) a deductible business expense of buying out the NHSC service obligation.²¹

19. Disputes ending in default often arise because the participant’s professional or personal situation may change during the five to eight years of his medical education, making the service obligation unexpectedly burdensome. For example, the participant may decide to specialize in a field which is unacceptable to the NHSC, or his family situation may make it inconvenient or impossible for him to serve at the site to which the NHSC assigns him. Often the dispute is over whether the location in which the participant has decided to practice does (or should) qualify as an approved site. For this reason Byrnes concludes that a loan repayment program would be more effective than the scholarship program, because participants would already have made their career choices before joining, and the loan repayments would take place only after actual service. Byrnes, *supra* note 17, at 846.

20. See, e.g., Seigler, *supra* note 10, at 26 (citing *United States v. Redovan* 656 F. Supp. 121 (E.D. Pa. 1986), *aff’d*, 826 F.2d 1057 (3rd Cir. 1987)).

21. The correct answer today, however, may be that the treble damages should be capitalized now that the “Indopco Regulations,” Treas. Reg. § 1.263(a)-4, -5 (2004), have become final as of December 1, 2003. These regulations require capitalization of a payment made by a taxpayer in order to terminate a contract providing the payee with the exclusive right to acquire or use the taxpayer’s property or services. This regulation appears to apply to the *Hawronsky* situation, and if so, to render Revenue Ruling 68-43 obsolete. Treas. Reg. § 1.263(a)-4(d)(7)(i)(B). Similarly, a

Along the way, however, the article finds much else to criticize in this problematic litigation. First, the “fine or similar penalty” language of I.R.C. § 162(f) is poorly conceived and has led to great confusion. Second, the judge-made “public policy doctrine,” which I.R.C. § 162(f) was intended to simplify and replace was itself highly questionable, and probably ought to have been legislated away rather than codified. And finally, the NHSC’s colossal treble-damage penalty seems harshly disproportionate to any actual harm that a scholarship participant’s breach might cause, and probably should never have been enacted.

II. *HAWRONSKY* AND I.R.C. § 162(F)

In *Hawronsky*, the taxpayer received a tax-exempt scholarship of approximately \$42,000 pursuant to the Indian Health Care Improvement Act and signed an NHSC Scholarship Program standard contract, which provided for payment of treble damages if he breached his service obligation.²² After serving approximately one year and eight months of his four years of required service, the taxpayer left his approved site in May of 1989, for reasons not stated in the published decision or the briefs,²³ and joined a private medical practice.²⁴ The NHSC declared him in breach of his contract, and the taxpayer was required to pay the Department of Health and Human Services (“HHS”) treble damages of approximately \$275,000 (of which \$126,000 represented trebled principal and \$149,000 represented trebled deemed interest).²⁵ On his income tax return for 1989, the taxpayer deducted all but \$42,000 of the damages, which was the original amount of the scholarship.²⁶ He deducted as a business expense \$ 84,000, which represented two-thirds (the trebled portion) of the principal, and also deducted the entire \$149,000 of trebled deemed interest.²⁷

taxpayer who buys his way out of a noncompete agreement must capitalize the payment under Treas. Reg. § 1.263(a)-4(d)(7)(iii), Example 3. However, the Indopco Regulations generally do not purport to change the cost recovery rules applicable to the intangibles, which must be capitalized. Thus, presumably such a payment as in *Hawronsky* would be amortized under I.R.C. § 167(a) ratably over the remaining period of the service obligation.

22. *Hawronsky v. Comm’r*, 105 T.C. 94, 95 (1995), *aff’d*, 98 F.3d 1338 (5th Cir. 1996).

23. The taxpayer apparently had a dispute with his employer, but after leaving, he continued to serve the poor in an underserved area, albeit not one approved by the Indian Health Service. Telephone Interview with Dr. John Hawronsky (June 29, 1999).

24. *Hawronsky*, 105 T.C. at 96. In December of that same year the taxpayer accepted other employment at a hospital for which he received a sign-on bonus of \$190,000. *Id.*

25. *Id.* at 96.

26. *Id.*

27. *See id.* at 96-97. Somewhat oddly the taxpayer deducted the “single” imputed interest of \$49,000 as “personal interest,” and the \$100,000 trebled portion as “mortgage interest.” *Id.*

The IRS claimed that the payment was not deductible under two theories. First, because it was a fine or similar penalty subject to I.R.C. § 162(f), and second, because it was entirely allocable to income exempt from tax (the tax-free scholarship) and therefore nondeductible under I.R.C. § 265(a)(1).²⁸

The Tax Court held that deduction of the payment was precluded by I.R.C. § 162(f) on the ground that “[t]he treble damages penalty at issue here was a penalty imposed on petitioner because he violated his obligation under [the statute],” and that the “treble damages penalty at issue here serves a deterrent and a retributive function similar to a criminal fine.”²⁹ Judge Colvin declined to address the I.R.C. § 265(a)(1) issue.³⁰

The *Hawronsky* decision is vitiated by two issues, which were not briefed and apparently not even noticed. First, the deemed interest portion of the single damages is clearly compensatory and therefore deductible. Second, although the trebled two-thirds of the damages paid is clearly a penalty, it is a penalty for a breach of contract, not for the violation of any law, and is thus outside the reach of I.R.C. § 162(f). Therefore, the entire treble damages should have been deductible, except for the original scholarship amount, just as the taxpayer reported.

In order to explain these errors, it is necessary to give some account of the history and purpose of I.R.C. § 162(f). The account is not intended to be complete, nor is it intended to be a full-fledged argument for repeal of I.R.C. § 162(f), although a good case might be made that its enactment was a mistake, and that the earlier judge-made public-policy doctrine that it replaced was misguided as well.³¹

A. History of I.R.C. § 162(f)

1. Pre-Codification Public Policy Doctrine

The earliest case of denial of a deduction for a business expense on the ground of public policy seems to be the 1924 decision in *Backer v. Commissioner*,³² in which the Board of Tax Appeals denied a deduction for the legal expenses of a taxpayer in the construction business who was

28. *Id.* at 97.

29. *Id.* at 98-99.

30. *See id.* at 101.

31. See James W. Colliton, *The Tax Treatment of Criminal and Disapproved Payments*, 9 VA. TAX REV. 273 (1989), for an article criticizing both.

32. 1 B.T.A. 214 (1924).

defending himself from a charge of perjury relating to the payment of a bribe extorted from him by labor union bosses.³³ The springboard for the government's inventive argument was the "ordinary and necessary" language of the predecessor section of what is now I.R.C. § 162(a). The government argued that the payment of a bribe, even under extortion, could never be ordinary or necessary in any business, and the Board agreed.³⁴ As the Board saw the matter, "[t]he question is whether the act whereby [the taxpayer] laid himself open to the charge of perjury was one which was ordinarily and necessarily committed in the course of his business. We are unable to see any proximate connection between the two."³⁵ Despite the court's statement, the bribe was quite obviously a business expense paid to avoid labor problems.³⁶ But the court was not yet ready to state more honestly – if not more reasonably – that some genuine business payments should be denied simply because they offend public policy. *Backer* was badly reasoned in another respect, which was not made fully clear until nearly forty years later, when the Supreme Court decided in *Commissioner v. Tellier*³⁷ that, guilty or innocent, everyone has the right to the services of an attorney to defend himself from criminal charges, and if the charges have a business origin, no public policy bars deducting the legal expenses.³⁸ In those forty years separating *Backer* and *Tellier*, the IRS attacked a great variety of business expenses as allegedly against public policy, and a large body of inconsistent and controversial case law developed.³⁹

The dangers and uncertainties of this "public policy" doctrine have often been pointed out: taxpayers whose behavior displeased judges would be taxed on a gross rather than a net basis, the limits of the doctrine would be intolerably uncertain and depend upon the unpredictable moral opinions of tax court judges, and the denial of otherwise legitimate deductions would simply add additional penalties for conduct that may already be punished.⁴⁰ Making the punishment fit

33. *Id.* at 215.

34. *Id.* at 216.

35. *Id.* at 217.

36. Sadly, and ironically, the reason why such bribes are often both ordinary and necessary is ultimately the government's failure to protect businessmen from extortion.

37. 383 U.S. 687 (1963) (allowing a deduction for legal expenses of unsuccessful defense of criminal charges of securities fraud).

38. *Id.* at 694.

39. See BORIS L. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS (3d ed. 1999) ¶ 20.3.3; see also Jacob L. Todres, *Internal Revenue Code Section 162(f): An Analysis and Its Application to Restitution Payments and Environmental Fines*, 99 DICK. L. REV. 645 (1995).

40. *Dixie Machine Welding & Metal Works v. United States*, 315 F.2d 439, 440-41 (5th Cir.

the crime is notoriously difficult even for prosecutors, legislators, and judges whose specialty is law enforcement, and there has never been much reason to think that tax judges would make any improvement in this area.⁴¹ Denying deductions on moral grounds has proved more likely to produce confusion in the tax law than to add anything to the sum of justice in the world.⁴²

The objections to denying deductions on the ground of public policy were very quatably summarized by Judge Bootle in *Dixie Machine Welding & Metal Works v. U.S.*:

The object of the income tax bill of 1913 was 'to tax a man's net income, that is to say, what he has at the end of the year, after deducting from his receipts his expenditures or losses. It is not to reform men's moral character; that is not the object of the bill at all.' 'Moral turpitude is a very poor criterion for taxability and * * * in the interests of good tax administration, Uncle Sam shall take his taxpayers as he finds them, exact his normal share of their net income, and let someone specifically charged with he job punish them for their sins. If the tax collector is required to sit in judgment on the morals of his clients, he will be doing something for which he has neither the training nor the knowledge and he will be adding to his already heavy administrative burdens. Furthermore, uneven and discriminatory application of the tax laws will result. There are too many different types and degrees of wickedness, and there are too many different attitudes toward sin on the part of tax officials and judges.' The Internal Revenue Code should not be used as a 'mandate for extirpating evil'; espousal of the public-policy concept would result in a tax on gross rather than net income, and thus be 'inconsistent with a code geared to the latter concept'; the public policy which declares a payment illegal also prescribes stated penalties therefor, and it would be inconsistent with the policy of the statute to add another penalty — loss of a tax deduction — not contemplated thereby; the tax penalty resulting from disallowance of claimed deductions might be absurdly disproportionate both to the nature of the offense and to the penalty therefor prescribed by statute; attempted enforcement by federal tax authorities of the policy of state statutes would have far reaching effects, of dubious advantage, on the distribution of law enforcement powers between the federal and state governments; and the state statutes or regulations relied upon as expressive of state policy may be but dead-letter proscriptions, 'nominal, not effective law', and not

1963).

41. *Id.*

42. *Id.*

expressive of current community sentiment at all. And not overlooked is the comment of Mr. Justice Burrough in England nearly a century and a half ago: 'I, for one, protest, as my Lord has done, against arguing too strongly upon public policy; — it is a very unruly horse, and when once you get astride it you never know where it will carry you. It may lead you from the sound law. It is never argued at all but when other points fail.'⁴³

We may add to these observations that even violation of a criminal statute is not automatically immoral or against the public interest. Only a naïf would believe all our criminal laws actually serve the public interest. Consider *Peckham v. Commissioner*,⁴⁴ for example, in which the taxpayer, a licensed physician, was denied a deduction for his legal expenses for unsuccessfully defending himself from the criminal charge of performing an illegal abortion. (Inexplicably, it did the taxpayer no good to invoke the Supreme Court's 1943 decision in *Commissioner v. Heininger*,⁴⁵ which allowed the deduction of legal fees incurred by a licensed dentist in his unsuccessful defense against a fraud order issued by the Postmaster General forbidding him to sell artificial dentures through the mail.) The Fourth Circuit explained: "There is no evidence in the record that the abortion which the taxpayer was charged with performing had anything to do with his practice of medicine."⁴⁶ We now know since the Supreme Court's 1973 decision in *Roe v. Wade*,⁴⁷ handed down only nine years after *Peckham*, that it was probably not the taxpayer, but instead (for the time being, at least) the State anti-abortion law which violated public policy.⁴⁸

The leading Supreme Court decision regarding fines and penalties before the 1969 codification of I.R.C. §162(f), *Tank Truck Rentals v. Commissioner*,⁴⁹ presented a situation that was almost as ironic. There, the taxpayer's overweight trucking fines paid for violations of Pennsylvania highway law were held nondeductible on the theory that allowing the deductions would "frustrate sharply defined national or state policies proscribing particular types of conduct,"⁵⁰ which are "evidenced by some governmental declaration" (that is to say, evidenced

43. *Id.* (citations omitted) (denying deduction for payment of illegal kickbacks for ship repairs, despite delightful rhetoric).

44. 327 F.2d 855, 857 (4th Cir. 1964), *aff'g* 40 T.C. 315 (1963).

45. 320 U.S. 467, 474-75 (1943).

46. *Peckham*, 327 F.2d at 857.

47. 410 U.S. 113 (1973).

48. *See id.*

49. 356 U.S. 30 (1958).

50. *Id.* at 33-34 (citing *Heininger*, 320 U.S. at 473).

by a statute).⁵¹ The Court believed permitting the deduction would remove some of the sting from the penalty, as indeed it would, at least for profitable taxpayers.⁵² On the other hand, whether reinforcing the sting was good policy is another matter because the weight law in question was so unrealistically strict that every trucking company that transported liquid chemicals was forced to violate it on every trip if it drove through Pennsylvania at all.⁵³ The Court was moved by neither the fact that the offending statute had already been repealed before the briefs were submitted, nor that the accounting system used by the Pennsylvania Public Utility Commission rate-making authorities treated the overweight fines as normal business expenses.⁵⁴

Eventually, confusion in the area of the “public policy” doctrine became insupportable, and Congress acted in 1969 to clarify the prior case law, codify it and make it more predictable. Enactment of I.R.C. § 162(f) in 1969 was part of this general codification.

2. Post-Codification: The Problem of Civil Penalties

Codification of the public-policy doctrine did at least provide some greater measure of certainty in this hazy area, and it did also generally follow the most recent Supreme Court decisions. Congress attempted both to specify which business expense deductions would be disallowed, and to preempt the field so that the IRS would be prohibited from denying any others.⁵⁵ New I.R.C. § 162(c) would deny deductions for illegal bribes, kickbacks, and certain other illegal payments, new I.R.C. § 162(g) would disallow the non-compensatory two-thirds of anti-trust treble damage payments, and new I.R.C. § 162(f) would deny any deduction for fines or penalties paid to a government⁵⁶ for the violation of any law, as in *Tank Truck Rentals*. These three sections, enacted at

51. *Id.*

52. *Id.* Denial of a deduction for fines is a very blunt instrument if the purpose is to enhance punishments. It may have no effect at all if the taxpayer is in a loss position. And even if the taxpayer is profitable, the punishment will have no deterrent effect if the fine cannot be avoided in any event, or if the transaction remains profitable notwithstanding the tax on gross rather than net income.

53. *Id.* at 32.

54. *Id.* See BITTKER & LOKKEN, *supra* note 39.

55. See I.R.C. § 162(f) (2006).

56. *Ostrom v. Comm’r*, 77 T.C. 608, 612 (1981). It appears that the only reason a separate section was required to forbid a deduction for the punitive two-thirds of Clayton Act treble damages is that the rule applies to damages paid to private plaintiffs, and thus such damages, although for a “violations of law,” are not paid to a government and so not prohibited under I.R.C. § 162(f). Punitive damages paid to non-governmental plaintiffs remain deductible. *Id.*

the same time, were explicitly intended to preempt the field, at least insofar as the doctrine applies to trade or business deductions.⁵⁷ The Senate Report explained:

The provision added by the committee amendments denies deductions for four types of expenditures. . . The provision for the denial of the deduction for payments in these situations which are deemed to violate public policy is intended to be all-inclusive. Public policy, in other circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions.⁵⁸

Thus, the damages payment in *Hawronsky* is either disallowed as a deduction under the specific terms of I.R.C. § 162(f), or it is allowable despite any possible misgivings about public policy.⁵⁹

As the Senate Finance Committee Report explained the codification of new I.R.C. § 162(f), it seemed to limit the disallowance of fines and penalties to purely criminal matters:

First, the committee amendments provide that no deduction is to be allowed for any fine or similar penalty paid to a government for the violation of any law. This provision is to apply in any case in which the taxpayer is required to pay a fine because he is convicted of a crime (penalty or misdemeanor) in a full criminal proceeding in an appropriate court. This represents a codification of the general court

57. The statutory preemption by its terms applies only to expenses, as opposed to otherwise deductible losses under I.R.C. § 165. On the other hand, it appears that courts are willing to use the principles of I.R.C. § 162(f) to determine whether a loss should be disallowed on public policy grounds. See *Stephens v. Comm'r*, 905 F.2d 667, 672 (2d Cir. 1990). Properly speaking, a loss from a transaction, as opposed to an overall loss from operations, implicitly involves only a loss from property, not an expenditure of money. See SHEPHERD'S TAX DICTIONARY 341 (Richard A. Westin ed., Shepard's/McGraw-Hill, Inc. 1990). Thus *Hawronsky's* cash buyout of his employment contract should be treated as an expense rather than a loss (unless, as noted above, it must be capitalized under the new *Indopco* Regulations). However, the expense would probably be capitalized and deducted over its useful life. See *infra* Part II.

58. S. REP. NO. 91-552, at 274 (1969), reprinted in 1969 U.S.C.C.A.N. 2027, 2311.

59. Unless the IRS and the courts simply ignore the statutory preemption, as may have happened in *Hawronsky v. Comm'r*, 105 T.C. 94 (1995), *aff'd*, 98 F.3d 1338 (5th Cir. 1996). See Robert R. Wood, *Denying Deductions Based on Public Policy*, TAX NOTES, March 27, 2006, at 1415, which points out that in *Car-Ron Asphalt Paving Co. v. Commissioner*, 758 F.2d 1132 (6th Cir. 1985), a deduction was denied for a kickback paid by a subcontractor to a general contractor that was legal under Ohio law, in clear violation of the requirement under I.R.C. § 162(c)(2) that the kickback can only be denied a deduction if it is illegal under state law. The court's reasoning was that the kickback was neither "ordinary" nor "necessary." *Car-Ron*, 758 F.2d at 1134. This decision is eerily reminiscent of *Backer v. Commissioner*, 1 B.T.A. 214 (1924), the very first of the public-policy decisions. The law of *Car-Ron* is the same as that in 1924, and perhaps the free-floating public-policy doctrine simply cannot be killed, even by Congress.

position in this respect.⁶⁰

After the enactment of I.R.C. § 162(f), doubt immediately arose as to whether the new provision was to apply solely to fines for criminal violations of law, as the above-quoted Senate Report indicated with its “convicted of a crime” language, or whether the new statutory phrase “fines or similar penalties” might extend to civil penalties as well, and in particular to the vast array of tax penalties and additions to tax. Some civil tax penalties had been disallowed under case law prior to the enactment of I.R.C. § 162(f), notably the penalty for negligent understatement of tax,⁶¹ the civil fraud penalty,⁶² and the 100 per cent penalty for willfully failing to collect a tax (predecessor of I.R.C. § 6672). If, as the Senate Report indicated, the new provision was intended to codify existing law, then should it not apply to these civil tax penalties as well, despite the same Report’s explicit limitation to criminal fines and penalties?

Two years later, using the occasion of Congress’ unrelated amendment of I.R.C. § 162(c) in Revenue Act of 1971, the Senate Finance Committee attempted to clarify matters by adding a supplementary explanation:

In connection with the proposed regulations relating to the disallowance of deductions for fines and similar penalties (section 162(f)), questions have also been raised as to whether the provision applies only to criminal “penalties” or also to civil penalties as well. In approving the provisions dealing with fines and similar penalties in 1969, it was the intention of the committee to disallow deductions for payments of sanctions which are imposed under civil statutes but which in general terms serve the same purpose as a fine exacted under a criminal statute. The provision was intended to apply, for example, to penalties provided for under the Internal Revenue Code in the form of assessable penalties (subchapter B of chapter 68) as well as to additions to tax under the Internal Revenue laws (subchapter A of chapter 68) in those cases where the government has the fraud burden of proof (i.e., proof by clear and convincing evidence). It was also intended that this rule should apply to similar payments under the laws of a State or other jurisdiction.⁶³

The Report went on to explain that:

60. S. REP. NO. 91-552 at 274.

61. *United States v. Jaffray*, 97 F.2d 488, 494 (8th Cir. 1938), *aff’d on another issue sub nom.*, *United States v. Bertelsen & Petersen Eng’g Co.*, 306 U.S. 276, 281-82 (1939).

62. *Helvering v. Mitchell*, 303 U.S. 391, 399 (1938).

63. S. REP. NO. 92-437 (1971), *reprinted in* 1971 U.S.C.C.A.N. 1918, 1979-80.

On the other hand, it was not intended that deductions be denied in the case of sanctions imposed to encourage prompt compliance with requirements of law. Thus, many jurisdictions impose “penalties” to encourage prompt compliance with filing or other requirements which are really more in the nature of late filing charges or interest charges than they are fines. It was not intended that this type of sanction be disallowed under the 1969 action. Basically, in this area, the committee did not intend to liberalize the law in the case of fines and penalties.⁶⁴

Despite this explanation, the final regulations under I.R.C. § 162(f) ignored the Senate Committee’s distinctions as they might apply to tax penalties, and disallowed any deduction for all penalties and additions to tax, no matter what the burden of proof might be, and without regard for whether the nature of the penalty indicates some degree of negligence or culpability, or is merely a late filing or late payment charge.⁶⁵

Notwithstanding the criminal-only application of I.R.C. § 162(f) described in the Senate Report’s 1969 explanation, it is firmly established that any civil penalty, not just civil tax penalties, may fall within the ambit of the language “fine or similar penalty” in I.R.C. § 162(f) if it serves the same purpose as a fine imposed under a criminal statute. This is also in accordance with pre-enactment case law.⁶⁶

3. What Does “Similar Penalty” Mean?

The Treasury has never contended that compensatory damages are governed by I.R.C. § 162(f) and its regulations hold flatly to the contrary. Treasury Regulation § 1.162-21(b)(2) clearly states in pertinent part that “[c]ompensatory damages. . .paid to a government do not constitute a fine or penalty.”⁶⁷ However, distinguishing civil penalties intended to deter or punish from compensatory damages paid to a government has proved to be a very difficult problem. In fact, nearly all the reported litigation under I.R.C. § 162(f) concerns this

64. *Id.*

65. See Treas. Reg. § 1.162-21(b)(ii) (1975) (disallowing deduction of all federal tax penalties and additions to tax).

66. See, e.g., *A. D. Juilliard & Co., Inc. v. Johnson*, 259 F.2d 837, 844 (2d Cir. 1958) (finding treble damages for Emergency Price Control Act civil penalty not deductible); *McGraw-Edison Co. v. United States*, 300 F.2d 453, 456 (Ct. Cl. 1962) (holding there is no deduction for payment to the United States in a settlement of breach of agreement providing “penalty” for employing child labor); *Tunnel R.R. of St. Louis v. Comm’r*, 61 F.2d 166, 174-75 (8th Cir. 1932) (finding that civil penalties under Safety Appliance Act are not deductible).

67. Treas. Reg. § 1.162-21(b)(2).

issue, and *Hawronsky* is no exception.⁶⁸ The inclusion of civil penalties within the ambit of I.R.C. § 162(f) thus undercut Congress' goal of simplifying the law, and was clearly a mistake to the extent that simplification was the principal goal of the 1969 codifications.

The leading case in the Tax Court is *Southern Pacific Railroad v. Commissioner*,⁶⁹ which held that civil penalties imposed for the purpose of enforcing the law and punishing violators are "similar" to a criminal fine within the meaning of I.R.C. § 162(f), and that civil penalties intended to encourage prompt compliance with the law, or to provide remedial compensation for losses resulting from a violation, are not "similar."⁷⁰ Whether the purpose of a penalty is to enforce and punish is the relevant question according to *Southern Pacific*, and not whether the punished conduct is of itself reprehensible or merely a regulatory infraction.⁷¹ Where a penalty serves a dual purpose of law enforcement and retribution as well as compensation, the Tax Court has held that it must determine the primary purpose of the penalty, principally by analysis of the statute under which the penalty (or damages) is imposed.⁷² It is often far from obvious where lines should be drawn, usually because all such payments at least arguably have some elements of both characters. In apparent frustration at the difficulty of this inquiry the Federal Circuit gave up the attempt altogether in the isolated decision *Colt Industries, Inc. v. United States*,⁷³ and declined to consider the remedial *vel* punitive purpose of the environmental penalties at issue, stating that the "purpose" inquiry is not prescribed either by statute or regulations, and that it is not the role of the judiciary to make its own

68. 105 T.C. 94 (1995), *aff'd*, 98 F.3d 1338 (5th Cir. 1996).

69. 75 T.C. 497, 646-54 (1980) (holding that penalties incurred in 1959, 1960, and 1961, for violations of the Safety Appliance Act, 45 U.S.C. §§ 1-16, and the Twenty-Eight Hour Act, 45 U.S.C. §§ 71-74, were imposed to enforce the law, to punish violations thereof, and to fall within the scope of the term "fine or similar penalty" in I.R.C. § 162(f), where such violations were nondeductible under both prior judicial law and I.R.C. § 162(f)).

70. *Southern Pacific* 75 T.C. at 652.

71. *Id.* (finding that many of the violations were unavoidable and very common in the industry).

72. *S & B Rest., Inc. v. Comm'r*, 73 T.C. 1226, 1232 (1980) (discussing the dual purpose of the Pennsylvania Clean Streams Law as punishing illegal discharges and developing pollution control, and finding that the agreed-to particular payments at issue were not penalties in part because the amounts were open-ended and based upon charges petitioner would have had to pay if a municipal sewage facility had been available).

73. 880 F.2d 1311 (Fed. Cir. 1989) (denying a deduction for \$1.6 million paid to Pennsylvania Clean Air and Clean Water Funds pursuant to a consent decree and a settlement agreement of suit brought by the Environmental Protection Agency for multiple violations of the Clean Air and Clean Water Acts).

assessment of the deductibility of a particular penalty.⁷⁴ This approach would have left the issue of deductibility entirely to the discretion of the IRS. *Colt Industries* has not been followed by other courts, however, which continue to apply the “purpose” test set forth in *Southern Pacific*.⁷⁵

The parties themselves may determine the characterization of a penalty by their own settlement agreement.⁷⁶ For example, in *Middle Atlantic Distributors, Inc. v. Commissioner*,⁷⁷ a payment in settlement of penalties and damages under 19 U.S.C. § 1592 for fraudulent violations of customs laws was held deductible because, after determining that the statute was a dual-purpose one, the Tax Court decided that the parties’ characterization of the payment as “liquidated damages” must be given tax effect.⁷⁸ Similarly, in *Grossman & Sons, Inc. v. Commissioner*,⁷⁹ where the taxpayers characterized their settlement offer, which was accepted by the government, as “contractual damages,” a deduction for the amount paid was held not to be against public policy.⁸⁰ This despite the fact that the government’s suit was for civil fines and double damages under the False Claims Act,⁸¹ and that the taxpayers had already been criminally convicted and fined under related provisions for the same conduct.⁸² On the other hand, the total amount of the settlement was apparently far less than the government’s “single” damages.⁸³

74. *Id.* at 1314.

75. *Stephens v. Comm’r*, 905 F.2d 667, 672-73 (2d Cir. 1990).

76. *Middle Atlantic Distribs., Inc. v. Comm’r*, 72 T.C. 1136, 1146 (1979).

77. 72 T.C. 1136 (allowing the taxpayer to deduct a settlement of \$100,000 for violating customs laws by fraudulently withdrawing liquor from its warehouse without paying required import duties and alcohol taxes).

78. *Id.* at 1146.

79. 48 T.C. 15 (1967) (finding that amounts paid in a settlement of a government suit under the False Claims Act for penalties and double damages for fraudulently mislabeling and overbilling the Navy were deductible because the taxpayer characterized the offer, which was accepted by the government, as “contractual damages”).

80. *Id.* at 29.

81. 31 U.S.C. §§ 3729-3731 (2006).

82. *Grossman*, 48 T.C. at 18.

83. *Id.* at 22. In a remarkably similar case, *Talley Industries Inc. v. Commissioner*, 77 T.C.M. (CCH) 2191 (1999), where the parties had *not* indicated whether \$940,000 of a \$2.5 million settlement was intended as compensation or as penalty under the False Claims Act, the taxpayer was unable to shoulder his burden of proof that the disputed \$940,000 was not in lieu of penalties, and was denied a deduction. The remaining \$1.56 million of the settlement was the Navy’s estimate of its own actual “singles” losses, not including the government’s investigatory expenses. *Id.* The government had never tried to establish the exact amount of its losses and relied on projections and estimates based on false billing in 1984. *Id.* In the Tax Court’s first decision, 68 T.C.M. (CCH) 1412 (1994), the taxpayer was allowed to deduct the entire \$2.5 million on the ground that the

Other factors that have been considered in determining whether a given exaction is predominantly compensatory in nature are whether the payment is structured so that the amount increases in proportion to the harm done,⁸⁴ whether the exactions are used for remediation of the harm, and whether liability is strictly imposed. Oddly enough, liability without fault has sometimes triggered the tax punishment.⁸⁵ The courts have not had an easy time sifting these various factors.

B. NHSC Treble Damages: Penalty or Compensation?

The Tax Court cited many of the above decisions in *Hawronsky*, but did not attempt to apply their precepts with any rigorous argument.⁸⁶ Instead, it held for the government, with the conclusory announcement that the NHSC liquidated damages are a nondeductible penalty because “[t]he treble damages amount has no demonstrated relationship to the cost imposed on the Government of replacing petitioner’s services.”⁸⁷ The Tax Court suggested that Congress intended the treble damages to be punitive by quoting a somewhat cryptic statement from the legislative history of the 1975 changes to the NHSC scholarship program, which trebled the damages for breach of the service obligation, according to which the NHSC “is not intended. . .solely to subsidize health professional education, ‘but as a means to overcome a geographic maldistribution of health professionals.’”⁸⁸ Despite its cursiveness, the Tax Court was correct on both counts, and so was its conclusion that the treble damages are a penalty and not compensatory. Both the replacement cost and “maldistribution penalty” arguments are discussed below in the following sections.

Most of the Tax Court’s opinion was devoted not to these

settlement was far less than double damages, and there was no evidence that any of the amount was intended as a penalty. The Ninth Circuit, 116 F.3d 382, 388 (9th Cir. 1997), reversed and remanded to determine the purpose for which the \$940,000 excess over the Navy’s estimate of its actual damages was paid.

84. *Mason and Dixon Lines, Inc. v. United States*, 708 F.2d 1043, 1047 (6th Cir. 1983) (examining liquidated damages for a trucking company’s violation of Virginia weight laws and holding the damages deductible where they were determined by degree to which weight exceeded the legal limits, and where separate sanction of nondeductible fines were also applicable).

85. *True v. United States*, 894 F.2d 1197, 1210 (10th Cir. 1990) (holding that the penalty paid for discharge of oil in violation of Federal Water Pollution Control Act is not deductible and reversing the district court’s holding that the penalty was primarily compensatory because assessments were used to defray cleanup costs and because strict liability was intended to shift fault to the party best able to bear cost and insure risk).

86. *Hawronsky v. Comm’r*, 105 T.C. 94 (1995), *aff’d*, 98 F.3d 1338 (5th Cir. 1996).

87. *Id.* at 99.

88. *Id.* at 99-100 (quoting S. REP. 94-887, at 201 (1975)).

arguments, but rather to discrediting the taxpayer's reliance on seemingly airtight authorities imported from a non-tax area, namely contract law.⁸⁹ The question in these cases was whether under contract law the NHSC treble damages are enforceable in the first place, or whether they constitute an unenforceable penalty.⁹⁰ The taxpayer relied upon four Federal District Court decisions,⁹¹ which appear precisely on point and held that the NHSC treble damages are not a penalty, but rather compensatory in nature. The NHSC scholarship participants in these cases resisted enforcement on the ground (among many other grounds) that the treble damages were so excessive as to be unenforceable under the common law doctrine disfavoring penalty clauses in contracts.⁹² All of these decisions held for the government, however, and found that the damages were compensatory in nature and therefore valid and enforceable liquidated damages.⁹³

In *United States v. Swanson*,⁹⁴ the first of these decisions, the District Court found that the harm suffered by the government from loss of the physician's services is not limited to the actual monies expended. The court explained that:

To estimate the damages which would be suffered by the loss of services of a trained . . . physician for a three year period in a medically underserved area is difficult, if not impossible, to accurately determine. The Court cannot say that [the treble] damages which the government [is] entitled to receive for Defendant's breach of the contract bears no relation to the actual damages suffered by the government, or that they were not a fair and reasonable attempt to fix just compensation in the event of breach.⁹⁵

The *Swanson* court then held in summary judgment for the government that the liquidated damages clause was valid and enforceable as a reasonable estimate of probable damages, which are difficult to predict.⁹⁶ *Priebe & Sons, Inc. v. United States*⁹⁷ held that the

89. See *Hawronsky*, 105 T.C. 94.

90. *Id.* at 98-99.

91. *United States v. Swanson*, 618 F. Supp. 1231 (E.D. Mich. 1985); *United States v. Hayes*, 633 F. Supp. 1183 (M.D.N.C. 1986); *United States v. Fowler*, 659 F. Supp. 624 (N.D. Cal. 1987), *aff'd*, 849 F.2d 1476 (9th Cir. 1988); *United States v. Padavano*, 664 F. Supp. 28 (D. Me. 1987).

92. *Hawronsky*, 105 T.C. at 100.

93. See *Swanson*, 618 F. Supp. at 1244; see also *Hayes*, 633 F. Supp. at 1187; *Fowler*, 659 F. Supp. at 625; *Padavano*, 664 F. Supp. at 30.

94. 618 F. Supp. 1231.

95. *Id.* at 1243-44.

96. *Id.* at 1243 (citing *Priebe & Sons, Inc. v. United States*, 332 U.S. 407 (1947)).

97. *Priebe*, 332 U.S. 407.

same standards that applied to contracts with private parties applied to contracts with the government, namely that liquidated damages clauses that are not intended to be *in terrorem* penalties to compel performance are enforceable when they are fair and reasonable attempts to fix just compensation in advance for anticipated losses.⁹⁸

The *Swanson* decision was soon followed in at least three other District Court decisions in three other circuits.⁹⁹ If the government's losses include the harm to the underserved community deprived of the promised medical care, as the *Swanson* Court suggested, the harm is clearly impossible of measurement even *ex post*, much less *ex ante*, and might easily exceed the triple damages by far.

These District Court precedents would seem to guarantee the taxpayer victory. The NHSC stipulated payments for nonperformance are labeled damages by Congress,¹⁰⁰ compensatory damages are deductible according to the Treasury Regulations, and the federal courts had universally held these same damages to be compensatory rather than punitive, finding them a classic case for the appropriate use of enforceable liquidated damages. The taxpayer in *Hawronsky* lost nevertheless.

1. Opportunism in the Government's Litigating Position(s)

There is considerable opportunism in the government's contradictory positions. The very same NHSC treble damages are claimed to be "punitive" when that benefits the government under the tax law, but "compensatory" if that benefits the government under contract law. There is no obvious reason to suppose that "compensatory" and "punitive" ought to mean anything different for purposes of I.R.C. § 162(f) than for the interpretation of contracts, and in fact they do not. In both areas of law, the test is essentially the same: whether the amount of stipulated damages is a reasonable attempt to approximate probable damages in advance, or whether the amount is so much greater than any actual or reasonably expected damages that the clause is clearly intended to coerce performance by threat of punishment.¹⁰¹ The only differences are those of the realm of

98. *Id.* However, the Court held the particular clause at issue to be an unenforceable penalty because under it the government was incapable of suffering any loss at all. *Id.* at 413.

99. *United States v. Hayes*, 633 F. Supp. 1183 (M.D.N.C. 1986); *United States v. Fowler*, 659 F. Supp. 624 (N.D. Cal. 1987), *aff'd*, 849 F.2d 1476 (9th Cir. 1988); and *United States v. Padavano*, 664 F. Supp. 28 (D. Me. 1987).

100. 42 U.S.C. § 254o(b)(1)(B)(i)-(iii) (2006).

101. *Hawronsky v. Comm'r*, 105 T.C. 94, 98 (1995), *aff'd*, 98 F.3d 1338 (5th Cir. 1996).

application: the common-law unenforceability doctrine is of course limited to contracts, and the denial of a tax deduction is limited to penalties paid to a government, and most importantly for *Hawronsky*, penalties paid “for the violation of any law.”¹⁰²

The Tax Court seemed to accept this identity of meaning in contract and tax law, but was nevertheless unmoved by the *Swanson* line of cases.¹⁰³ It announced as a conclusion that “[t]he treble damages penalty serves a deterrent and a retributive function similar to a criminal fine,” and then explained that *Swanson* and its progeny cited by the taxpayer were “unpersuasive here because they were decided before Courts of Appeal for the Fifth and Ninth Circuits held that statutory intent and not contract principles govern the parties’ obligations under 42 U.S.C. 254o and that Congress intended treble damages imposed under 42 U.S.C. sec. 254o to be an enforceable civil penalty.”¹⁰⁴

A closer look at the Circuit Court decisions cited by Judge Colvin does not entirely bear out this interpretation. Nothing in these Circuit Court holdings directly contradicts or reverses the District Courts’ unanimous conclusion that the treble damages are compensatory liquidated damages. Instead, they render the whole question irrelevant by holding that common law contract principles, such as the common law disfavor of penalty clauses, simply do not apply to NHSC contracts because Congress decreed by statute that the triple damages must be enforced unless it would be impossible or unconscionable to do so.¹⁰⁵

Judge Colvin cited *Rendleman v. Bowen*,¹⁰⁶ *United States v. Hatcher*,¹⁰⁷ *United States v. Citrin*,¹⁰⁸ *United States v. Arron*,¹⁰⁹ and

102. *Id.* at 97.

103. *See id.* at 100.

104. *Id.* at 99-100.

105. *Id.* at 101.

106. 860 F.2d 1537 (9th Cir. 1988) (finding a participant who left his residency program without notice to NHSC, failed to match to a site on HPOL, and practiced in a poverty area of Portland, Oregon without the permission of NHSC, but who believed he was in compliance with his service obligation, was in default for refusing to report to NHSC’s placement for him in Evergreen, Alabama, despite the fact that in the following year the site of his Portland practice was designated a qualifying HPSA location). The court determined that Congress intended participants to comply with procedures delegated to NHSC, and that NHSC followed its procedures. *Id.* The District Court remanded to the NHSC to determine whether a waiver for time served was warranted. *Rendleman v. Sullivan*, 760 F. Supp. 842 (D. Or. 1991), *rev’d sub nom.*, *Rendleman v. Shalala*, 21 F.3d 957 (9th Cir. 1994).

107. 922 F.2d 1402 (9th Cir. 1991) (following *Rendleman*, and determining that whether a participant osteopath is in default should be determined not by contract principles, but under the Administrative Procedure Act; and finding the NHSC preference for residency-trained physicians not arbitrary or capricious and the failure to disclose this preference did not stop the government from enforcing damage clause).

United States v. Melendez,¹¹⁰ for the proposition that statutory principles, not contract principles, apply to the NHSC program. The Ninth Circuit in *Rendleman* was the first to announce this doctrine, reversing the District Court below, which had held for the NHSC participant on the ground that the NHSC had abused its authority by unreasonably refusing to credit Rendleman for his service in an area that should have been approved as a HMSA.¹¹¹ The Ninth Circuit reversed on the ground that Congress had granted the NHSC sole authority to designate shortage areas, and Rendleman had not complied with the NHSC procedures for placement.¹¹² Despite its holding for the government, the court was visibly disturbed by the fact that Rendleman had set up a huge practice in a poverty area that had twice as great a shortage of physicians as the average HMSA, and that Rendleman had repeatedly tried without success to persuade the NHSC to designate the area of his practice as a HMSA.¹¹³ The Ninth Circuit remanded with the suggestion that the District Court refer the case back to the NHSC for reconsideration of whether Rendleman should be given credit for his service.¹¹⁴ The matter was sent back to the NHSC, which again refused to waive the treble

108. 972 F.2d 1044 (9th Cir. 1992) (applying legislative intent standard and not contract principles; finding that NHSC did not repudiate contract for alleged change of policy by disallowing deferral of service to in order to complete anesthesiology residency where participant failed to submit required request to NHSC; and finding that participant's due process rights were not violated by the magnitude of damages).

109. 954 F.2d 249 (5th Cir. 1992) (applying legislative intent standard and not contract principles). In *Arron*, the court found that NHSC did not act arbitrarily or capriciously by allegedly failing to mail the recipient forms that were required to request deferment. *Id.* The court further found that remanding to NHSC is not required to consider a waiver for time served on the ground that the participant was practicing in a Louisiana hospital that NHSC designated an HPOL site a year after participant refused to go to the Texas assignment. *Id.* NHSC has the discretion to determine waiver for "extreme hardship or good cause shown" under 42 U.S.C. § 254o(c)(3) (2006), a provision that is applicable only to the loan repayment program under 42 U.S.C. § 254o(l)-1 – the applicable waiver provision for the scholarship program is at 42 U.S.C. § 254o(d)(2). *Id.* Here, the participant made none of these showings. *Id.*

110. 944 F.2d 216, 219-20 (5th Cir. 1991) (finding contract principles irrelevant following *Rendleman* and that a participant did not qualify for waiver where he was discharged from approved service site in Texas and thus unemployed for one and one-half months while NHSC sought a new site, he made no claim under Administrative Procedure Act, and he provided no evidence that refusing to report to new assignment was due to impossibility or extreme hardship which would qualify for waiver under 42 U.S.C. § 254o(d)(2)).

111. *Rendleman*, 860 F.2d at 1544.

112. *Id.*

113. The NHSC did finally qualify the area as a HMSA, but it refused to assign Rendleman to the practice he had built in Portland, Oregon. *Id.* It instead ordered him to Alabama, where he refused to go, and then held Rendleman in default. *Id.*

114. *Id.*

damages.¹¹⁵ Rendleman resisted again, and again the District Court referred the case back to the NHSC for reconsideration.¹¹⁶ This is the end of the reported litigation, and Rendleman apparently succeeded in avoiding payment.¹¹⁷ Ironically, *Rendleman*, which first established the doctrine that participants have no rights to common law contract defenses such as partial performance, is also the only case in which a participant ever succeeded in avoiding the treble damages despite having defied the NHSC's orders and served the poor in his own manner and according to his own judgment.¹¹⁸

The Ninth Circuit's *Rendleman* doctrine held that no common law contract defenses such as unconscionability, economic duress, partial performance or estoppel apply to NHSC contracts¹¹⁹ because Congress itself set forth the only defenses to breach of an NHSC contract, either explicitly or by delegation to HHS,¹²⁰ so that NHSC decisions are reviewable only as claims under the Administrative Procedure Act.¹²¹ After *Rendleman*, it is no longer relevant to the enforceability of NHSC damages whether they are a penalty or not, at least in the Fifth Circuit (to which *Hawronsky* was appealable) and in the Ninth Circuit.¹²² But even assuming that *Rendleman* was correctly decided,¹²³ it did not overrule or disapprove *Swanson*'s holding that the NHSC treble damages are compensatory.¹²⁴

Contrary to what the Tax Court suggested, a large number of post-

115. *Rendleman v. Sullivan*, 760 F. Supp. 842, 844 (D. Ore. 1991), *rev'd sub nom.*, *Rendleman v. Shalala*, 21 F.3d 957 (9th Cir. 1994).

116. *Id.* at 846.

117. *Id.*

118. *Id.*

119. *Rendleman*, 860 F.2d at 1542; *United States v. Hatcher*, 922 F.2d 1402, 1405 (9th Cir. 1991); *see also United States v. Westerband-Garcia*, 35 F.3d 418, 421 (9th Cir. 1994); *United States v. Bloom*, 112 F.3d 200, 204 (5th Cir. 1997).

120. The regulations implementing the 42 U.S.C. § 254o(d)(2) statutory standard for waiver for impossibility, extreme hardship or unconscionability are at 42 C.F.R. § 62.12 (2006).

121. *See Hatcher*, 922 F.2d at 1405.

122. *Rendleman*, 860 F.2d at 1542.

123. The *Rendleman* doctrine is by no means self-evidently correct, and it has been questioned. *See Illinois Dept of Public Health v. Jackson*, 747 N.E.2d 474 (Ill. App. Ct. 2004) (reversing and remanding circuit's imposition of treble damages for court to determine, *inter alia*, whether a participant in Illinois medical scholarship program similar to NHSC that practiced in poverty area without approval of agency deserved credit for time served as equivalent to "substantial performance"). The *Jackson* majority declined to follow the *Rendleman* line of cases, and pointedly asked "If the government chooses to enter into contracts with an individual, why should the individual be subject to the law of contracts, but the government not be?" *Id.* at 478. *But see Dept. of Public Health v. Wiley*, 810 N.E.2d 614 (Ill. App. Ct. 2004) (adopting the *Rendleman* doctrine and rejecting *Jackson*).

124. *See United States v. Swanson*, 618 F. Supp. 1231 (E.D. Mich. 1985).

Rendleman decisions continued to cite *Swanson* for the proposition that the treble damages are compensatory, and no federal enforcement decision rejects the *Swanson* doctrine.¹²⁵ For example, in *United States v. Vanhorn*,¹²⁶ the participant claimed, *inter alia*, that the treble damages were “unconscionable.” The Fourth Circuit disagreed, quoting *Swanson*.¹²⁷ Other post-*Rendleman* decisions approving *Swanson* on the penalty question include *United States v. Hugelmeyer*,¹²⁸ *United States v. Turner*,¹²⁹ and *United States v. Maldonado*.¹³⁰

On the other hand, universal approval and constant repetition is no guarantee that the *Swanson* doctrine is correct. *Swanson* was decided on motion for summary judgment, and the penalty issue was but one of five issues decided.¹³¹ It was treated in cursory fashion, and no facts or legal analysis whatsoever were adduced to support the conclusion that the government’s losses were either incapable of proof or that the treble damages were a reasonable attempt to estimate the government’s expected damages.¹³² The decisions following *Swanson* on the penalty issue simply quoted *Swanson*, and made no analysis either.¹³³ The *Swanson* line of cases seems clearly wrong for several reasons, which were not considered in any of the reported enforcement litigation.¹³⁴

First, the measure of damages for breach of an employment contract (assuming the NHSC contract is one) is the replacement cost of the employee. Second, the NHSC does not, as a general rule, replace

125. *Rendleman*, 860 F.2d at 1542.

126. 20 F.3d 104 (4th Cir. 1993) (finding that there was no agency action to review since the participant never sought a waiver and that contract defenses such as substantial compliance and estoppel were irrelevant to NHSC contracts). In *Vanhorn*, the participant practiced without written NHSC approval in Anacostia, D.C., which was adjacent to a designated HPSA, believing that the site was approved. *Id.* She claimed she never received required application forms from NHSC, but was still held in default. *Id.* Her later refusal to report to Amarillo, Texas under a forbearance agreement was her second default. *Id.* The participant’s third default was her failure to apply for an appropriate site under a second forbearance agreement. *Id.* Participant’s arguments ultimately failed because she did not advance any claim of abuse of discretion under the APA and never sought a waiver from NHSC. *Id.*

127. *Id.* at 113 (quoting *Swanson*, 618 F. Supp. at 1243-44); see also *supra* note 65.

128. 774 F. Supp. 559, 561 (D. Ariz. 1991) (acknowledging and approving the statutory-interpretation theory of *Rendleman*, but stating that regardless of the statutory language it would address the participant’s affirmative defenses, including the defense that the damages were unenforceable as a penalty, but nonetheless denying this defense pursuant to *Swanson*).

129. 660 F. Supp. 1323 (E.D.N.Y. 1987) (making the same finding as *Hugelmeyer*).

130. 867 F. Supp. 1184 (S.D.N.Y. 1994) (making the same finding as both *Hugelmeyer* and *Turner*, but without mentioning the *Rendleman* doctrine).

131. See *Swanson*, 618 F. Supp. 1231.

132. See *id.* at 1242-44.

133. *Id.*

134. *Id.*

defaulters, and when it does so, it is solely through its internal programs at the same cost as it paid the defaulter, that is, the scholarship amount. Third, most defaulters are not NHSC employees in the first place. The actual on-site employer (if any) can hardly have any rights under scholarship contracts entered into years before any particular employer or site could have been contemplated by the parties. For the same reason, the public to be served at any particular site can have no rights under the scholarship contract. And finally, the legislative history of the treble damages, the corresponding penalties (or lack of any) in State programs similar or identical to the federal programs under the NHSC, and the actual behavior of the NHSC itself, all point unmistakably to the conclusion that the treble damages are and are intended to be a punishment.

The reader who is interested solely in tax law may safely skip all these issues and pick up at section C *infra*.

2. Replacement Costs

Under contract law generally, the proper measure of an employer's loss from an employee's breach of contract is the cost of finding a substitute, as the Tax Court correctly suggested in *Hawronsky*.¹³⁵ A stipulated damages cause for an employee's breach of contract may also include additional consequential damages not otherwise allowable and still be enforceable, but only if such consequential damages are reasonable in amount, and if the parties clearly contemplated and negotiated the stipulated damages clause with such consequential damages in mind.¹³⁶ The Sixth Circuit's decision in *Vanderbilt University v. DiNardo*¹³⁷ provides a well-reasoned modern account of the law regarding a stipulated damages clause in an employment contract, which bears some similarities to the damages clause in a NHSC contract.¹³⁸ In *Vanderbilt*, the head football coach resigned before the end of his five-year contract, and Vanderbilt successfully enforced a liquidated damages clause that required DiNardo to pay to Vanderbilt an amount equal to his base salary for each year remaining on his

135. See *Hawronsky v. Comm'r*, 105 T.C. 94, 100-101 (1995), *aff'd*, 98 F.3d 1338 (5th Cir. 1996).

136. *Vanderbilt Univ. v. Dinardo*, 174 F.3d 751, 756 (6th Cir. 1999).

137. *Id.*

138. See Gregory Scott Crespi, *Measuring "Actual Harm" for the Purpose of Determining the Enforceability of Liquidated Damages Clauses*, 41 HOUS. L. REV. 1579, 1601-03 (2005); 11 ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS, § 58.7 (Joseph M. Perillo ed., rev. ed. Supp. 2005).

contract.¹³⁹ DiNardo resisted payment on the ground that the clause was an unenforceable penalty, but the District Court below enforced the clause on summary judgment on the ground that the provision was reasonable in relation to the anticipated damages for breach, measured prospectively at the time the contract was entered into.¹⁴⁰ These anticipated damages included consequential damages not ordinarily awarded by law because the parties contemplated them.¹⁴¹ In *Vanderbilt*, the court noted that the contract itself recited the importance of a “long-term commitment” for “the University’s desire for a stable intercollegiate football program,” and accepted Vanderbilt’s explanation that it was impossible to estimate how the loss of a head coach might affect alumni relations, public support, football ticket sales, and the like.¹⁴² The contract had been negotiated by lawyers, and the liquidated damages clause was reciprocal.¹⁴³ In addition, Vanderbilt presented evidence that its actual expenses for recruiting a new coach, including the new coach’s moving expenses, and the incremental salary it had to pay, were very nearly equal to the amount claimed under the liquidated damages clause.¹⁴⁴

None of the conditions are present in an NHSC contract that might indirectly permit, as in *Vanderbilt*, allowing consequential damages over and above simple replacement cost. The NHSC contract recites nothing about any (otherwise noncompensable) consequential or unforeseeable harm as the reason for the enormous amount of stipulated damages, and in fact provides no reason at all for the treble damages.¹⁴⁵ The terms of the NHSC contract are obviously not negotiated on equal terms at arms length; they are not negotiated at all. The student who participates must take or leave the government’s contract as it stands.¹⁴⁶

139. *Vanderbilt*, 174 F.3d at 753-54.

140. *Id.* at 755.

141. *Id.* at 755-56.

142. *Id.* at 756

143. *Id.* at 757.

144. *Id.*

145. Of course, the NHSC damages clause has nothing reciprocal about it either, nor has the government ever even tried to prove any consequential losses over and above its investment in the contract. See 42 U.S.C.S. § 254o(b)(1)(A) (2006).

146. The student undoubtedly assumes that when the time for service comes, the NHSC administrators will be reasonable and supportive in helping him to select a proper site for his service obligation, and that the treble damages clause could never apply to him as long as he is willing to serve the poor. He overlooks entirely that he has signed away any real choice of his own, and that he has written a blank check to the NHSC to enforce its own desires. For NHSC contract provisions, see *Stroud v. United States*, 906 F. Supp. 990, 991 (D.S.C. 1995), *vacated on other grounds*, 94 F.3d 642 (4th Cir. 1996).

It may be questioned on several grounds whether even the general rule of cost-of-substitute-employee should be considered the standard of reasonableness for NHSC damages. First, less than ten per cent of NHSC physicians are actually employees of the government.¹⁴⁷ The vast majority are employed by a hospital or clinic, or are self-employed. In most instances the NHSC role is limited to facilitating a match between a participant and an employer at the site, and the actual terms of employment are negotiated by the parties themselves. The NHSC neither trains nor pays these participants.

Second, in actual practice, the NHSC does not replace defaulting physicians except from within the Corps itself,¹⁴⁸ either through the scholarship program, or through the related Loan Repayment Program (LRP), which will be described below. If no replacement from the Corps is found (or sought¹⁴⁹), the position simply remains unfilled. The NHSC never replaces a physician by paying whatever the market price might be, and it is doubtful whether the NHSC has the authority to do so if it wanted. Under these circumstances, the proper measure of replacement cost should probably not be based upon the experience of other employers who might pay the market price for primary-care physicians, because such costs will never be borne by the government. The inquiry must be focused on the expected replacement costs that the government might actually bear.¹⁵⁰

The *Swanson* Court assumed that no such evidence is available, and made no attempt to discover any.¹⁵¹ It restated as a fact the government's assertions that "a physician...is not a 'fungible handyman'" and that "the loss of the services of a trained osteopathic physician...is difficult, if not impossible, to accurately determine."¹⁵² This seems almost comical in view of the fact that the NHSC service commitment is designed strictly for beginners who are straight out of internship or residency and are unlikely to possess unique expertise. Indeed, the NHSC program generally forbids extending even residency

147. Telephone Interview with Pauline Cooper, Chief of Compliance, NHSC, in Rockville, Md. (June 29, 1999). The government-employed physicians are mainly in the Indian Health Corps, or federal prisons. *Id.*

148. *Id.*

149. A replacement might not be sought at all because the NHSC considers other sites a higher priority or, in some cases, because the number of defaulters at a site persuades the NHSC that the site management is poor. Telephone Interview with Dr. Don Weaver, Director, NHSC, in Rockville, Md. (Nov. 4, 2004).

150. *See generally* United States v. Swanson, 618 F. Supp. 1231 (E.D. Mich. 1985).

151. *Id.*

152. *Id.* at 1243-44.

training for more than three years, or in fields other than primary care.¹⁵³ The services of one new graduate should probably be considered no more valuable than those of another, and in any case, issues of differential compensation are either left to negotiation between the site employer and the participant, or, in the rare case of direct employment by the government, are governed by a fixed civil service pay scale, which belies as a matter of law any differential value between beginners at the same level.¹⁵⁴ If we can put aside the “uniqueness” issue as spurious, good evidence of actual replacement costs appears to be available from the both the Scholarship and the LRP programs themselves.

An additional participant can always be obtained at the cost of simply funding one more scholarship, and that is in principle the measure of loss (plus the duplicated administrative costs of selection and ultimate placement). The scholarship program has limited funding, and has always had more applicants than scholarships available.¹⁵⁵

It is not a valid objection that the NHSC would have to wait some five to nine years for the services of a replacement. The government could easily protect itself from personnel attrition simply by expanding the program to reflect the anticipated level of default. The program would remain fully staffed at the originally desired level, and as long as the “single” damages (and single imputed interest) for breach made the government whole for its actual costs, the government would lose nothing by anticipating and absorbing the breaches. Congress was aware of the extent of the problem of breach in 1975, and instead of expanding the program, it responded by trebling the damages.¹⁵⁶

3. The Loan Repayment Program

The NHSC Loan Repayment Program (“LRP”) provides still more direct evidence for replacement costs.¹⁵⁷ Enacted in 1987, at least in part due to the friction in the Scholarship Program, the LRP¹⁵⁸ pays down a participant physician’s student loans (undergraduate and medical school) at the rate of \$35,000 per year (plus another \$9,000 per year to cover

153. The dispute in *Swanson* itself was caused by the participant’s decision to enter a lengthy surgical residency rather than fulfill his service obligation immediately. *Id.*

154. See 42 U.S.C.S. § 254d(d) (LexisNexis, LEXIS through Dec. 2006 amendments).

155. See *Swanson*, 618 F. Supp. at 1235.

156. Public Health Service Act, 42 U.S.C. §§ 331-338G (1976), amended by 42 U.S.C. §§ 254d-254r (1990).

157. U.S.C. § 2541-1(g)(2)(A), (g)(3)(A) (2006).

158. *Id.*

income taxes) in exchange for an agreement to serve in a medical shortage area.¹⁵⁹ The participants are already licensed physicians at the time of applying to the program, and they apply to serve at a particular site only after having seen it, and in some instances, after having already commenced work at the site. Thus the LRP eliminates much of the friction that mars the Scholarship Program, because the applicants already know exactly where they will work when they apply.

Breach of a LRP contract caused (until amendments enacted in 2002) the participant to incur a statutory obligation to repay the amounts actually received from the government (without imputed interest),¹⁶⁰ plus an “unserved obligation penalty” of \$1,000 per month for each month not served under a two-year contract (but if the participant does not serve at least one full year, the penalty is the full contract period multiplied by \$1,000).¹⁶¹ This obligation was far milder than the treble damages for breach of a scholarship contract, and yet Congress oddly termed it a “penalty” rather than “damages.” The LRP penalty is payable under the same conditions and for the same loss to the government as the scholarship treble damages.

The LRP program had in its early years about the same number of participants as the scholarship program, but it was much more popular, and physicians’ demand for the LRP exceeded its limited funding by far. Because of the popularity of the LRP, the NHSC was able to recruit participants to the highest priority (usually least desirable) sites, and so the annual HPOL list was not the same for the LRP and the Scholarship programs.¹⁶² Thus, it would be easy in most cases to replace a Scholarship Program dropout with an LRP participant, the replacement could be done within a short period of time, and the government’s expected cost would be \$44,000 per year, plus the administrative costs of selection. It is difficult to escape the conclusion that the replacement cost of a Scholarship participant during the years in question was \$44,000 per year, and that if the government cared to fund the LRP program sufficiently, the NHSC would never lose more than that amount from a scholarship breach. That amount was roughly the annual cost of

159. The LRP payments have been tax-free since 2002. Economic Growth and Tax Relief Reconciliation Act, Pub. L. No. 107-16 115 Stat. 38 (2001).

160. 42 U.S.C. § 254o(c)(1)(A) (2006).

161. MR. KENNEDY, HEALTH CARE SAFETY NET AMENDMENTS OF 2001, S. REP. NO. 107-83, at 26 (2001), as reprinted in 2002 U.S.C.C.A.N. 1033, 1057-58. Also, if the participant in a contract for over two years breaches after the first two years and fails to give a full year’s notice (or such shorter notice as the Secretary determines acceptable for finding a replacement), he is liable for an additional \$10,000.

162. Telephone Interview with Pauline Cooper, *supra* note 147.

medical school tuition and living allowance during the years in question. It follows that the treble damages are exactly what they appear to be: a penalty intended to coerce performance.¹⁶³ The penalty is actually much stiffer than the treble damages under the Clayton Antitrust Act, because it includes trebled deemed interest as well.¹⁶⁴ Under antitrust law, the judge at his discretion may grant at most single prejudgment interest and even then only if he finds that the defendant deliberately engaged in dilatory and delaying litigation tactics.¹⁶⁵

4. Third-party Beneficiaries

The *Swanson* line of cases assumed without analysis that the government's losses would include harm to the communities affected by the loss of expected medical services, and it was this loss that the *Swanson* court found to be both large and especially difficult to estimate.¹⁶⁶ But *Swanson* cited no authority for the proposition that the community losses would be compensable in an action for breach of contract, and in fact, it is all but certain that the contrary is true.¹⁶⁷ *Vanderbilt* teaches us that consequential damages not otherwise compensable may be included in an enforceable stipulated damages clause, provided the consequential damages were foreseen and agreed to by the parties to the contract, but even so, such consequential damages still must represent (estimated) losses of the promisee, and not losses of

163. Treble damages consist almost by definition of a compensatory portion of one-third, and a non-compensatory punitive two-thirds. See Field Service Advice Memoranda from Assistant Chief Counsel on Environmental Protection Fines to District Counsel, Atlanta, 1992 FSA LEXIS 199, at *9 (Sept. 28, 1992). With particular application to I.R.C. § 162(f), the IRS confirmed this in a 1992 Field Service Advice memorandum concerning the deductibility of environmental fines, although with some hesitation because the advice requested was in the abstract, without reference to any particular state or federal environmental statute:

With respect to treble damages, there is specific provision in the Code that prevents a taxpayer from deducting two thirds of the amount paid to satisfy the judgment or in settlement of a suit brought under section 4 of the Clayton Antitrust Act. I.R.C. § 162(g). However, there is no similar provision in the Code relating to treble damages with respect to violations of environmental laws. Nevertheless, even though there is no specific provision in the Code, we believe that an argument may be made that two thirds of any treble damage amount paid to satisfy the judgment or in settlement of a suit brought under an environmental law could be considered punitive in nature and therefore nondeductible. Our view is tentative at this point and further information about the particular statutory provision dealing with treble damages for violation of an environmental law would need to be evaluated before a definite conclusion can be made.

Id. at *9-*10.

164. Compare 42 U.S.C. § 254o (2006) with 15 U.S.C. § 15(a) (2006).

165. 15 U.S.C. § 15(a).

166. United States v. Swanson, 618 F. Supp. 1231, 1243-44 (E.D. Mich. 1985).

167. See *id.*

third parties, unless the contract clearly indicates otherwise.¹⁶⁸

There is no authority for the proposition that consequential losses borne entirely by third parties who are not even mentioned in the contract can or should be compensable. Such damages cannot be the foundation for the establishing the reasonableness of a liquidated damages clause unless at the very least they are explicitly mentioned in the contract, and perhaps not even then.¹⁶⁹ If a NHSC participant is hired at a site and leaves prematurely, it is the site employer who suffers the resulting loss of services, if any, or the site population itself, rather than the government. There appears to be no reported litigation over recovery of such losses with respect to a NHSC contract.

However, there is at least one reported case involving just such a contract between non-governmental parties. In *Suthers v. Booker Hospital District*,¹⁷⁰ Suthers, a medical student, entered into a contract with the Bulah Peery Memorial Scholarship Fund, Inc., a non-profit Texas corporation of Booker, Texas, under which the Fund was to support Suthers through medical school.¹⁷¹ In exchange, Suthers was to practice medicine for a period of ten years in Booker, which had been without a physician for 23 years.¹⁷² If Suthers failed to serve, the contract required him to repay the Fund the moneys advanced plus interest, and if Suthers failed to serve at least five years, an additional “penalty” of 50% was to be imposed.¹⁷³ Suthers practiced only five weeks in Booker.¹⁷⁴ The Fund sued and won its investment plus interest,¹⁷⁵ but other parties joined the suit as well.¹⁷⁶ A group of residents of Booker who were the intended beneficiaries of Suthers’ services demanded compensation for the loss of the medical services they expected, and the Booker Hospital District demanded compensation for an investment it allegedly lost from building a clinic in reliance on Suthers’ contract with the Fund.¹⁷⁷ These third parties lost.¹⁷⁸

The *Suthers* decision has been cited favorably for its refusal to allow damages for non-parties to the contract who are incidental third-

168. See generally *Vanderbilt Univ. v. Dinardo*, 174 F.3d 751, 756 (6th Cir. 1999).

169. *Id.* at 757.

170. 543 S.W.2d 723 (Tx. Ct. App. 1976).

171. *Id.* at 724.

172. *Id.* at 724, 733.

173. *Id.* at 732.

174. *Id.* at 725.

175. The Fund apparently did not demand its 50% penalty, and so that was not in issue in the litigation. See *id.*

176. *Id.* at 736.

177. *Id.* at 725-26.

178. *Id.* at 729.

party beneficiaries.¹⁷⁹ The *Suthers* reasoning would appear to apply *a fortiori* to a NHSC contract, because in *Suthers* the would-be third party beneficiary patients and investors were at least identifiable at the time of making the contract, knew of the contract at the time it was made, and so had some reason to hope to benefit from it.¹⁸⁰ By contrast, in an NHSC contract, no site population or site employer could have been identifiable at the time of its making, because that occurs many years before a participant is matched to any eventual site, if indeed he is ever matched. It is inconceivable that such unidentifiable parties could have any claim in their own right to losses from the participant's failure to serve. And it is difficult to see how the government has any right of its own under the contract to sue on their behalf. Note, too, that when the government does collect treble damages, the funds are paid over to the U.S. Treasury and are not used to increase the funding of the NHSC,¹⁸¹ much less to compensate any site employer or local community.

5. Punish, Punish!

The legislative history of the treble damages provision under 42 U.S.C. 2540 makes its purpose reasonably clear. In the first five years of the program, from 1972 until 1976, the statutory damages for breach of an NHSC contract were single, that is, return of the amounts advanced by the government plus imputed interest.¹⁸² The amendment requiring treble damages was accompanied by the much-quoted statement in the Senate Report that the program was “not intended as a mechanism solely to subsidize health professional education,” but “as a means to overcome a geographic maldistribution of health professionals.”¹⁸³ Judge Colvin in *Hawronsky* correctly interpreted this statement to mean that Congress intended the treble damages to be a penalty.¹⁸⁴ During the hearings, one

179. See *Houston Oilers v. Harris County*, 960 F. Supp. 1202, 1206 (S.D. Tex. 1997); *Gonzalez v. City of Mission*, 620 S.W.2d 918, 922 (Tex. App. 1981); *McClellan v. Scardello Ford, Inc.*, 619 S.W.2d 593, 597 (Tex. App. 1981); *UTL Corp. v. Marcus*, 589 S.W.2d 782, 785 (Tex. App. 1979).

180. *Suthers*, 543 S.W.2d at 734-35 (Ellis, J., dissenting).

181. U.S.C. § 2540-1(c)(2) provides for a Replacement Fund, which is supposed to use any treble damages collected from defaulters to finance the training of additional NHSC members. Curiously, this fund was never established, though it seems to be required by law, and I have been unable to discover why, not even from the Director of the N.H.S.C. Telephone Interview with Dr. Don Weaver, *supra* note 149.

182. Siegler, *supra* note 10, at 320.

183. *Rendleman v. Bowen*, 860 F.2d 1537, 1541 (9th Cir.1988).

184. 105 T.C. 94, 99 (1995), *aff'd*, 98 F.3d 1338 (5th Cir. 1996) (citing *United States v. Melendez*, 944 F.2d 216, 219 (5th Cir. 1991)).

expert physician objected to the change as “essentially punitive.”¹⁸⁵ The Report can only be read as a statement that the original single-damages price of breach was too low, so low that it encouraged participants to default at no real cost, in effect giving them a right to rescind the NHSC contract at will. And the initial experience of the NHSC confirmed that many would do so if they found the service obligation inconvenient.

State programs similar to the NHSC existed long before the federal program, the first being that of Arkansas initiated in 1940, more than thirty years before the federal program.¹⁸⁶ According to Kristine Byrnes, at least 25 States have similar scholarship programs, and many have had similar problems with retention rates.¹⁸⁷ The reaction of the States has been quite varied.¹⁸⁸ According to Byrnes, most States have simply accepted the “buy-out” option,¹⁸⁹ others have enacted penalties that require medium or high rates of interest plus simple repayment of principal.¹⁹⁰ Only two States charge penalties of double or triple the amount of the scholarship,¹⁹¹ and only one State charges doubled interest.¹⁹² No State charges trebled interest.

The federal penalty is thus by far the stiffest of all the programs. Even if the federal penalty were fully deductible at the highest 35% rate, it would still be no higher than the (uniquely) highest State penalty for the same default. No doubt that is one reason why there is so much litigation over enforcing it, but little or no reported litigation growing out

185. *Health Manpower Legislation, 1975: Hearings on S. 989 Before the Subcomm. On Health of the Senate Comm. on Labor & Public Welfare*, 93d Cong., 2d Sess. 2017 (1975) (statement of Tom E. Nesbitt, American Medical Association), *quoted in* *Buongiorno v. Sullivan*, 912 F.2d 504, 509 n.4 (D.C. Cir. 1990).

186. Byrnes, *supra* note 17, at 819.

187. *Id.* at 820.

188. *See id.* at 822.

189. Byrnes, *supra* note 17, at 822 n.114; *see also, e.g.*, ME. REV. STAT. ANN. tit. 20-A, § 12104 (2006) (stating that loans can be repaid or cancelled through service); MISS. CODE ANN. § 37-143-5 (2006) (allowing a recipient to elect to repay with interest or cancel loan through service).

190. *See, e.g.*, CAL. HEALTH & SAFETY CODE § 128275(b)(10) (requiring the full amount plus interest at 2% above prime at time of contract); KAN. STAT. ANN. § 74-3267(a)(3) (requiring a defaulting physician who participated in the state’s osteopathic medical service scholarship program to pay all money loaned plus accrued interest plus 5% interest calculated from date of receipt).

191. Byrnes, *supra* note 17, at 822 n.114; *see also, e.g.*, N.Y. EDUC. LAW § 605(4) (McKinney 2006) (requiring the penalty to be twice the amount of the loan not discharged by service); 110 ILL. COMP. STAT. ANN. 935/10 (West 2004) (requiring students defaulting on scholarship required to pay “3 times the amount of the annual scholarship grant for each year the recipient fails to fulfill such obligation”); NEB. REV. STAT. § 71-5668(3) (2006) (requiring 125% if repayment recipient discontinues practice prior to completion of three year requirement).

192. MO. ANN. STAT. § 191.540(2) (West 2006) (“Such penalty shall be twice the sum of the principal and the accrued interest.”).

of the State penalties.¹⁹³

The NHSC openly uses the treble damages as a threat to coerce its participants into locations where they are unwilling to go. We have already seen that the NHSC orders defaulters (who are not necessarily at fault, but may simply have run afoul of the NHSC regulations) to sign “forbearance” agreements acknowledging their present indebtedness for the treble damages, and agreeing to serve if the government forbears to enforce the confessed indebtedness. But that in turn removes whatever little choice the participant may have had, and the NHSC can and does use this method to order the defaulter to the most undesirable locations on the HPOL.¹⁹⁴ This use of the penalty obviously has nothing to do with compensation for any supposed losses, and is simply the means by which the NHSC attempts to maintain absolute control of the site selection process.

Indeed, sometimes it even appears that the NHSC would rather punish disobedience than provide medical care for the underserved. For example, in *Matthews v. Pineo*,¹⁹⁵ the Third Circuit reversed a decision of the District Court to uphold the bankruptcy discharge of one-half of a debt of nearly \$400,000 for NHSC treble damages on the ground that the defaulting physician had not shown that nondischarge would be “unconscionable.”¹⁹⁶ Although it would be nearly impossible for Dr. Matthews to pay off her NHSC obligation on her current income of \$85,000 per year, she had not demonstrated to the bankruptcy court that she could not have earned more by changing her practice or relocating to a higher paying area.¹⁹⁷ The facts as reported by the Third Circuit indicate that Dr. Matthews was practicing at the Conneaut Valley Health Center in Crawford Valley, Pennsylvania, which was in fact on the NHSC’s Opportunity List as needing an internist.¹⁹⁸

Dr. Matthews was not an internist but rather a specialist in family practice, but she took the position at Conneaut anyway, over the objection of the NHSC, which had assigned her to South Dakota

193. See *supra* note 123 (discussing two Illinois decisions).

194. It is difficult to see how any student gains anything from accepting an NHSC scholarship. If a student is accepted into medical school, he can always finance the education through student loans. He can always serve the poor later if he chooses, and even obtain the same or similar financial benefits through a state or federal LRP program all without the risk of incurring the treble damages penalty.

195. 19 F.3d 121 (3d Cir. 1994).

196. *Id.* at 125.

197. *Id.* at 124.

198. *Id.* at 123.

instead.¹⁹⁹ The result desired by the NHSC seems to have been that Dr. Matthews should stop treating the poor in an underserved area, and instead move to a high-paying urban practice so that she can pay off her damages.

Even more surprising is the case of *Buongiorno v. Sullivan*,²⁰⁰ in which the NHSC interpreted its own regulations regarding waiver of the service or treble damages for impossibility or unconscionability to mean that even if it is *impossible* for a participant to serve through illness or other incapacity, he must still pay the treble damages.²⁰¹ This goes beyond using punishment as a tool for coercion and appears more like punishment for its own sake. Judge (now Justice) Thomas, though a little taken aback at the ruthlessness of the NHSC, nevertheless approved the NHSC's interpretation because Congress had delegated to the NHSC the right to make its own rules, and he reversed the lower court's more humane determination that the NHSC's regulations as interpreted were unreasonable.²⁰²

Whether the NHSC's strict command-and-control regulations and its enormous powers of punishment are really necessary for the success of its mission is beyond the scope of this article. Having taken the reader this far, however, it seems worth pointing out that the Director of the NHSC now allocates as much of the NHSC's funds as possible to the Loan Repayment Program and as little as possible to the Scholarship program.²⁰³ This would appear to indicate that he has come to agree with the judgment of Kristine Byrnes that the LRP would generate far less friction.²⁰⁴ On the other hand, friction and litigation may start up

199. *Id.* at 123.

200. 912 F.2d 504 (D.C. Cir. 1990) (holding that NHSC was within its authority to interpret 42 U.S.C. § 254o(d)(2) to mean that even if service would involve extreme hardship, waiver of payment participant must show separately and independently that enforcing payment would also involve extreme hardship or unconscionability). In *Buongiorno*, the participant demanded a waiver of service because his wife's medical condition rendered her immobile and she could not receive adequate treatment in remote places. *Id.* The court ultimately held that a participant must pay the treble damages even if he is completely without fault. *Id.* This interpretation is as illogical as it is heartless. If the participant must pay anyway, it is pointless to apply for the proffered waiver of service. After all, participants can always "waive" the service obligation unilaterally and at any time if they are willing to buy their way out. The NHSC apparently would force every participant to pay, even one who is utterly incapacitated for service, if he has or can find the means to pay, say through an inheritance or (why not?) even a personal injury damages award compensating him for his incapacity.

201. *Id.* at 510.

202. *Id.* at 508.

203. Telephone Interview with Dr. Don Weaver, *supra* note 149.

204. Byrnes, *supra* note 17, at 846.

now in the LRP too, because in 2002 legislation,²⁰⁵ Congress increased the amount of the penalty for breach of an LRP agreement from \$1,000 per unserved month to \$7,500 per month.²⁰⁶ The sole explanation Congress offered for this change was that the unserved obligation penalty would now be more nearly equal to that for breach of a scholarship agreement.²⁰⁷

C. *The Errors in Hawronsky*

1. The Untrebled Deemed Interest is Compensatory and Deductible

The *Hawronsky* Court appeared to take the statutory formula for NHSC treble damages at its face value and treat the single damages as actual damages.²⁰⁸ A necessary consequence of this (correct) interpretation is that the single deemed interest is an element of compensatory damages and thus deductible. The deemed interest called for in the treble damages clause is not interest for tax purposes, but rather an element of damages to compensate the government for the loss of the use of its money. It is not interest for tax purposes because the taxpayer incurred no indebtedness at the time of entering into the scholarship contract. Unfortunately this issue was completely overlooked.

It is well established that in the absence of actual indebtedness which is presently enforceable, there can be no interest for tax purposes.²⁰⁹ This rule applies to all types of contingent debt even if the contingent debt does become actual and enforceable after some intervening event. In that case, only the interest that accrues *after* the debt becomes actual and enforceable is interest for tax purposes, and “interest” that accrued before the debt became enforceable may be

205. Health Care Safety Net Amendments of 2002, Pub. L. No. 107-251, sec. 1533, § 313, 116 Stat. 1621, 1651-52 (2002).

206. 42 U.S.C. § 254o(c)(1)(B) (2006).

207. MR. KENNEDY, HEALTH CARE SAFETY NET AMENDMENTS OF 2001, S. REP. NO. 107-83, at 26 (2001), *as reprinted in* 2002 U.S.C.A.N. 1033, 1057-58. The report states in pertinent part that the Act “. . . revise[s] the loan repayment default provision by increasing the unserved obligation penalty from \$1,000 per month to \$7,500 per month. The value of the loss of a clinician’s services to an underserved community (upon default) should be roughly equal under both the scholarship and loan repayment programs. However, the average loan repayment debt is \$57,948, while the average scholarship debt is \$252,296.” *Id.*

208. *Hawronsky v. Comm’r*, 105 T.C. 94, 100-01 (1995), *aff’d*, 98 F.3d 1338 (5th Cir. 1996).

209. *Rozpad v. Comm’r*, 154 F.3d 1, 2 (1st Cir. 1998).

recoverable as an element of damages for the loss of the use of principal, but it is not interest for tax purposes.²¹⁰ This rule applies, for example, to “pre-judgment interest” that is an element of damages, but is not interest for tax purposes because no valid and enforceable debt is created until judgment.²¹¹ The IRS itself acknowledged that this rule applies to the very same NHSC treble damages at issue in *Hawronsky* in its own memorandum,²¹² which explicitly states that the deemed interest of the damages clause is not interest for tax purposes for exactly this reason, citing (correctly) *Appeal of Bettendorf*.²¹³ The single imputed interest was clearly compensatory by the government’s own analysis as well as the Tax Court’s, and a deduction should have been allowed because it is not a penalty.

2. For the Violation of Any Law

An even greater mistake in *Hawronsky* was that the court completely overlooked the final phrase of I.R.C. § 162(f) “for the violation of any law,” which was neither briefed nor discussed.²¹⁴ Even if damages paid to a government are indisputably punitive in nature, in order to fall within the disallowance provision, the penalty must still be paid “for the violation of any law.” Thus, punitive damages payable to a government in a tort action presumably are not within the ambit of I.R.C. § 162(f), nor is a penalty clause in a government contract, no matter how egregious the breach or how punitive the ensuing damages may be, unless they are imposed for the violation of a law.²¹⁵ Although the phrase has apparently never been interpreted in a judicial decision, the IRS has acknowledged at least once, in GCM 39596,²¹⁶ which

210. *Id.* at 5.

211. *See e.g., id.* (citing cases supporting this proposition). *See generally* Alice G. Abreu, *Distinguishing Interest from Damages: A Proposal for a New Perspective*, 40 BUFF. L. REV. 373, 398-414 (1992).

212. I.R.S. Gen. Couns. Mem. 39,336 (Feb. 5, 1985) (concluding that I.R.C. § 265 prevents deduction of the treble damages).

213. 3 B.T.A. 378, 385 (1926) (finding that damages for wrongful detention of funds is not interest on indebtedness for tax purposes).

214. *Hawronsky v. Comm’r*, 105 T.C. 94 (1995), *aff’d*, 98 F.3d 1338 (5th Cir. 1996). The Tax Court’s decision in *Hawronsky* was affirmed without opinion by the Fifth Circuit. 98 F.3d 1338.

215. There seems to be no reported example of either, apart from *Hawronsky*.

216. I.R.S. Gen. Couns. Mem. 39,596 (Sept. 26, 1986). This General Counsel Memorandum was issued subsequent to, but did not mention, *Hawronsky*. The taxpayer had imported commodities into the United States for less than the manufacturer’s cost or “fair value.” *Id.* The Commerce Department found that this did or was likely to injure local industry, which in turn triggered an obligation to pay anti-dumping duties. *Id.* The IRS found that the purpose and effect of the statute was remedial in nature, and that the quantum of duties imposed under the statute did

concerned the deductibility of anti-dumping duties, that the phrase has independent significance and must be satisfied before I.R.C. § 162(f) can apply.²¹⁷

The Tax Court appears to have been at least dimly aware of this difficulty when it insisted that the taxpayer “violated” obligations that are “established by statute” rather than by contract.²¹⁸ The implication seems to be that because the terms of the NHSC contract, including the definition of “breach” and the quantum of “damages” are fixed by statute, a violation of the contract is *ipso facto* a violation of law. Or perhaps Judge Colvin meant to suggest even more, that the NHSC contract is not a contract at all, but rather a “law.”

This second interpretation is easily refuted. In *United States v. Westerband-Garcia*,²¹⁹ the defendant had signed an NHSC contract, but he failed to apply for a deferment or to fulfill his service obligation.²²⁰ The government sued for breach of contract, and the participant argued that the statute of limitations provision in 28 U.S.C. § 2415(a)²²¹ barred the government’s action to collect damages.²²² In holding that the statute of limitations did apply to the NHSC scholarship agreement, the Court of Appeals stated:

We reject the government’s understanding of the NHSC scholarship agreement as noncontractual. Throughout the statute establishing the National Health Service Corps Scholarship Program, 42 U.S.C. § 2541, Congress described the agreement between the scholarship recipient and government as a “contract.” This plain language indicates that Congress intended the NHSC scholarship agreement to be a contract.

not exceed the amount necessary to equalize competition with U.S. produced commodities. *Id.* This alone would preclude the application of I.R.C. § 162(f). However, the IRS also pointed out that the settlement agreement between the taxpayer and the United States specifically recited that to the government’s knowledge the taxpayer’s conduct had violated no law. *Id.* According to the Memorandum, the terms of the agreement should be respected for tax purposes, and thus no “violation of law” existed which could trigger I.R.C. § 162(f). *Id.* The government carefully limited this concession in the agreement to any violation of the customs laws. *Id.* Thus the Memorandum suggests that even if the anti-dumping duties imposed under the statute exceeded the amount necessary for remediation, they would nevertheless be deductible despite I.R.C. § 162(f). *Id.*

217. *Id.*

218. *See id.*

219. 35 F.3d 418 (9th Cir. 1994).

220. *Id.* at 419.

221. Section 2415(a) provides, in pertinent part, that “every action for money damages brought by the United States . . . which is founded upon any contract expressed or implied in law or fact, shall be barred unless the complaint is filed within six years after the right of action accrues.” 28 U.S.C. 2415(a) (2007).

222. *Westerband-Garcia*, 35 F.3d at 420.

Further, the agreement the scholarship recipient signs are labeled a contract. The fact that the parties do not bargain for the terms of the agreement, but must take the terms as set forth in 42 U.S.C. 2541, does not mean that the agreement is not a contract .

The government's reliance on *Rendleman v. Bowen* and *United States v. Hatcher* to support its position that the scholarship agreement is not a contract is misplaced.²²³

Without question, the NHSC agreement is a contract. Does the fact that the terms of the contract are fixed by statute render a breach of the contract a "violation of law" within the meaning of I.R.C. § 162(f)? The answer is clearly negative for several reasons.

First, although the phrase "violation of any law" is nowhere defined, and "law" is a highly ambiguous term, it seems clear that what Congress meant was violation of a criminal statute or a civil statute of general application. In ordinary language, the phrase "violation of a[n] law" is a synonym for "breaking the law," and means noncompliance with a statute or government regulation of general application. The Supreme Court has said more than once that when interpreting the Code, one "should look to the 'ordinary everyday senses' of the words."²²⁴ One does not normally speak of actionable negligence or breach of contract as "violation of a law," notwithstanding that there exists a "law" of torts and a "law" of contracts.²²⁵ If this wider sense of "law" had been intended in I.R.C. § 162(f), the phrase "violation of law" would apply even to all forms of compensatory damages, because they are necessarily imposed by some "law" (e.g. of contracts), and thus the phrase would be pointless surplusage in the statute.²²⁶ It is a fundamental canon of statutory interpretation that the words of a statute must be given some meaning wherever possible.²²⁷

Second, the legislative history makes very clear that I.R.C. § 162(f) was intended to codify prior law, which applied exclusively to fines and

223. See *id.* at 420-21 (citations omitted); *United States v. Hatcher*, 922 F.2d 1402 (9th Cir. 1991); *Rendleman v. Bowen*, 860 F.2d 1537 (9th Cir. 1988).

224. *Comm'r v. Soliman*, 506 U.S. 168, 173 (1993) (quoting *Malat v. Riddell*, 383 U.S. 569 (1966)).

225. See H.L.A. HART, *THE CONCEPT OF LAW* 27-28 (2d ed., Oxford Univ. Press 1962).

226. Note also that in order to be valid, every contract with the government must be made pursuant to some statute. Even a run of the mill procurement contract must be authorized directly or indirectly by some appropriations law. If breach of a procurement contract is *ipso facto* a "violation of law" it would follow that the statutory language is largely *superfluous*, at least as it relates to contracts. Any and all breaches of a government contract would constitute a "violation of law."

227. MIKE SINCLAIR, *A GUIDE TO STATUTORY INTERPRETATION* 146 (2000) (citing *Stowers v. Wolodzko*, 191 N.W.2d 355, 362 (Mich. 1971)).

penalties under criminal *statutes* and to certain *statutory* civil tax penalties, all of which are rules of general application intended to deter and penalize all persons who fail to abide by the statute.²²⁸ The Senate Report states that “[i]n approving the provisions dealing with fines and similar penalties in 1969, it was the intention of the committee to disallow deductions for payments of sanctions which are imposed under civil *statutes* but which in general terms serve the same purpose as a fine exacted under a criminal *statute*.”²²⁹ It seems impossible to squeeze into this category damages for breach of an obligation that is incurred only by voluntary agreement.

Third, there is case law that indirectly confirms that the NHSC treble damages clause is not subject to I.R.C. § 162(f). Even where a penalty clause is required by a statute to be included in a government contract, as in the NHSC contract at issue in *Hawronsky*, it is still the purpose of the penalty that governs the analysis under I.R.C. § 162(f). If the penalty serves the sole purpose of coercing performance, there is presumptively no public policy at stake. Put another way, if a non-governmental party might enter into a similar contract and might wish to coerce performance by including a similar penalty, then the government is not acting in its governmental capacity, and the penalty is not punishment for violating “sharply defined national or state policies proscribing particular types of conduct.”²³⁰

There is no reason why a non-governmental civic group might not contract to pay a medical student’s expenses in exchange for his promise to serve in the community following graduation, and in fact, *Suthers v. Booker Hospital District*²³¹ is just such a case. In the *Suthers* contract the civic group has the same incentive to include a penalty for non-performance that any other contracting party has, namely to coerce performance.²³² If a government is substituted for the civic group, and includes a penalty for exactly the same purpose, the penalty should be outside the reach of I.R.C. § 162(f) because the penalty serves no public policy of deterring prohibited behavior.

This analysis is confirmed by a pre-codification decision on precisely this point, and oddly enough it was cited in the *Hawronsky*

228. Treas. Reg. § 1.162-21(c) (1975) (giving eight examples of statutes or regulations of this sort).

229. S. REP. NO. 92-437 (1971), reprinted in 1971 U.S.C.C.A.N. 1918, 1980 (emphasis added).

230. *Comm’r v. Heininger*, 320 U.S. 467, 473 (1943).

231. 543 S.W.2d 723, (Tex. App. 1976). See *supra* notes 170-78 and accompanying text (discussing *Suthers*).

232. 543 S.W.2d at 729.

opinion itself,²³³ although its significance was unfortunately overlooked. In *McGraw-Edison Co. v. United States*,²³⁴ the taxpayer had entered into government contracts to produce fuses, and as required by the Walsh-Healey Public Contracts Act, the contracts contained liquidated damages clauses designed to prohibit the employment of boys under 16 and girls under 18 years of age from performing the contracts by penalizing the company the sum of \$10 per worker per day for any violations.²³⁵ The taxpayer paid the liquidated damages for violation of the child-labor penalty provisions in the contracts, deducted the penalties, and sued to recover overpaid income taxes.²³⁶ The Court of Claims denied the deductions under the public policy doctrine, and its analysis is illuminating.²³⁷ The court stated explicitly that contractual penalties may be deducted even if prescribed by statute, unless, as in *Hawronsky*, the statute has a public-policy purpose unrelated to the objectives of the contract:

Obviously these “damage” payments were not designed to make the United States whole for any loss which it incurred. Conceivably child labor is poor labor, but the \$ 10 per day sum is not related to defects in workmanship. Nor can it be said that the plaintiff was unjustly enriched by the use of underage employees.

To be sure amounts paid by a contractor to a private party as “penalties” for failure to comply with its obligations under the contract would ordinarily be deductible since no specific legislation there expresses a state policy. Similarly amounts paid to a governmental agency as penalties to secure performance of a contract could properly be regarded as a “necessary” expense of doing business within the meaning of the *Tank Truck* case even if prescribed by statute. But here the sums paid under the Walsh-Healey provisions of the contract are wholly unrelated to the specific objectives designed to be secured by that particular agreement. The Government in requiring that the clauses in question be inserted in its contracts was not acting like a private purchaser of fuses, but was using, legitimately, its far-reaching power to contract as it pleases to secure objectives of a social and economic nature. The purpose of the Walsh-Healey Act “is to use the leverage of the Government’s immense purchasing power to raise labor standards.” The source of national power cannot, of course,

233. *Hawronsky v. Comm’r*, 105 T.C. 94, 98 (1995), *aff’d*, 98 F.3d 1338 (5th Cir. 1996).

234. 300 F.2d 453 (Ct. Cl. 1962).

235. *Id.* at 454.

236. *Id.* at 453.

237. *Id.* at 456.

affect the sharpness of national policy. Thus, we conclude that the damages provided for by the contract were in fact penalties designed to assure that child labor would not be used in the performance of government contracts and, as such, are not deductible.²³⁸

By contrast, the NHSC damages are intended solely to secure performance of its contracts. The penalty does not further any unrelated social welfare objectives, or deter any undesirable behavior other than nonperformance of the contract. It is irrelevant that increased rural health care is in the public interest. The production of properly functioning weaponry for the military is no less important, but it is quite clear that penalties for late or non-conforming production would be deductible even if the contractual penalties were required by statute.

III. CONCLUSION

The decision in *Hawronsky* is erroneous (among other problems) because the taxpayer violated no law. A wider conclusion one may draw is that *Hawronsky* is (yet more) evidence that the codification of I.R.C. § 162(f) did not fulfill Congress' hope for simplification and did not end uncertainty and confusion by preempting the "public policy" doctrine. This doctrine appears to be alive and well in spite of its supposed statutory demise in 1969.

A more disturbing conclusion is that the courts have deferred to the government in nearly every aspect of litigation with the NHSC, both with respect to enforcement of the treble damages and to their deductibility, sometimes in violation of the law, or common sense, or both, as if it were absolutely essential that the NHSC should prevail at any cost. This despite the fact that the treble damages penalty itself is very questionable as a policy matter. Congress was unwise to enact the treble damages, as it was unwise to enact I.R.C. § 162(f). The NHSC has made unnecessarily cruel use of the penalty, and the IRS made erroneous interpretations of law. The lawyers representing the NHSC victims of the treble damages often failed to identify essential issues, and the courts allowed the government to steamroller them. The final irony is that of all the actors in this drama, including Congress, the courts, the NHSC bureaucracy, and the lawyers on both sides, Dr. Hawronsky may arguably be the only party who did not act in violation of some public policy.

238. *McGraw-Edison Co.*, 300 F.2d at 456 (citations omitted).