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LABOR RELATIONS

Expert Analysis

Supreme Court Review: Severance, Affirmative Action, SOX, FLSA

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This is the first of two columns discussing decisions issued by the U.S. Supreme Court during the 2013-2014 term in the area of labor and employment law. In this column, we address the court's rulings in cases involving rights of a state's citizens to repeal affirmative action policies, the scope of the whistleblower provisions of the Sarbanes Oxley Act (SOX), the meaning of donning and doffing clothes under the Fair Labor Standards Act (FLSA) and whether severance pay is subject to withholding taxes.

Affirmative Action

In a highly anticipated decision, the Supreme Court in *Schuette v. Coalition to Defend Affirmative Action*, 134 S.Ct. 1623 (2014), upheld an amendment to the Michigan constitution that bans affirmative action in public university admissions. The ruling resolved a circuit split in favor of allowing states to repeal affirmative action policies in the public sector through state constitutional amendments. The decision is an important step in the analysis of affirmative action issues and therefore noteworthy for employers.

Schuette involved Michigan voters' adoption of a 2006 ballot initiative (known as Proposal 2) amending the Michigan constitution to prohibit granting preferential treatment to any individual on the basis of race, sex, color, ethnicity or national origin in public employment, public education and public contracting. The measure was enacted just three years after the court decided *Grutter v. Bollinger*, 539 U.S. 306 (2003), which held the University of Michigan Law School could grant admissions preferences to minority applicants. In response to Proposal 2's passage, civil rights groups filed suit in federal court challenging its provisions as applied to public universities.

The U.S. Court of Appeals for the Sixth Circuit held Proposal 2 violated the "political process doctrine," derived from the Equal Protection Clause, by removing the decision whether to include racial preferences in admissions from state universities' elected governing boards and lodging it in the state constitution; thus, racial minorities could only get preferential treatment in admissions by amending the state constitution, whereas other groups, like athletes or legacy applicants, could still simply lobby universities' governing boards.

The Supreme Court reversed the Sixth Circuit in a 6-2 ruling. The plurality decision, written by Justice Anthony Kennedy, emphasized the Schuette case is not about the constitutionality or merits of race-conscious admissions policies in higher education, which was addressed by the court in *Grutter* and again last term in *Fisher v. University of Texas*, 133 S.Ct. 2411 (2013). Rather, *Schuette* focuses on whether a state's citizens may choose to prohibit the consideration of racial preferences in governmental decisions.

The court concluded, "There is no authority in the Constitution of the United States or in this Court's precedents for the Judiciary to set aside Michigan laws that commit this policy determination to the voters." It stated that to hold otherwise would be an affront to the First Amendment and "inconsistent with the underlying premises of a responsible, functioning democracy." The court rejected the Sixth Circuit's application of the political process doctrine, concluding that doctrine applies where the action in question is designed to inflict injury on minorities.

In a passionate dissent, Justice Sonia Sotomayor concluded the Michigan amendment violated the Equal Protection Clause, explaining, "The Constitution does not protect racial minorities from political defeat. But neither does it give the majority free rein to erect selective barriers against racial minorities."

SOX Coverage

In *Lawson v. FMR LLC*, 134 S.Ct. 1158 (2014), the Supreme Court held that the SOX whistleblower protections (Section 1514A) extend to employees of privately held companies that contract or subcontract with public companies—not just to those employed directly by a public company. This holding drastically expands the coverage of SOX and will sweep in millions of privately held employers who may have assumed they were not covered by SOX.

Section 1514A of SOX provides in part, "No [public] company…, or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because" the employee provided information or otherwise assisted in an investigation of a fraud. 18 USC §1514A(a). Thus, the language clearly prohibits contractors and subcontractors of public companies from retaliating against whistleblowers.

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The issue in *Lawson* was whether only employees of the public company were protected from retaliation, or whether employees of the public company's contractors and subcontractors, such as employees of its investment advisers, were also protected.

The plaintiffs were employed by privately held investment funds and management firms which

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provided services to publicly traded mutual funds. The funds themselves had no employees. The plaintiffs alleged they were retaliated against for raising claims of fraud in accounting and SEC reporting with respect to the mutual funds. The employer argued SOX whistleblower protection applied only to employees of public companies, and moved to dismiss. The district court denied the motion to dismiss, but the U.S. Court of Appeals for the First Circuit reversed, holding Section 1514A protects only employees of public companies.

In a 6-3 decision authored by Justice Ruth Bader Ginsburg, the Supreme Court reversed the First Circuit, holding Section 1514A protects not only employees of public companies, but also employees of their private contractors and subcontractors. The court looked to the text of Section 1514A, and noted the ordinary meaning of "employee" presumes an employer-employee relationship. Thus, it would not make sense to prohibit a contractor from retaliating against employees of a public company, but allow the contractor to retaliate against its own employees for raising claims of fraud at the public company.

The court also looked to SOX's legislative history. SOX was passed in the wake of the Enron scandal, and the court noted that contractors and subcontractors such as accountants allegedly knew of Enron's conduct. In addition, the court explained that in the mutual fund industry, it is common for the fund to have no employees. Thus, "if the whistle is to be blown on fraud" at a mutual fund, it would have to involve another company's employee.

Justices Sotomayor (joined by Justices Kennedy and Samuel Alito) dissented, cautioning that, "[b]y interpreting a statute that already protects an expansive class of conduct also to cover a large class of employees, today's opinion threatens to subject private companies to a costly new front of employment litigation."

Donning, Doffing

In *Sandifer v. U.S. Steel Corp.*, 134 S.Ct. 870 (2014), the Supreme Court held that time spent donning and doffing (putting on and taking off) protective gear constitutes "changing clothes" under the FLSA, and a union and employer may bargain over whether such time is compensable time.

Employees of U.S. Steel Corporation were required to wear certain protective gear, including a flame-retardant jacket, pants and hood; a hard hat; a snood; wristlets; work gloves; leggings; boots; safety glasses; earplugs; and a respirator. Under the collective bargaining agreement (CBA), the employees were not paid for the time spent donning and doffing these items. The employees sued, seeking back pay for such time.

Defendant agreed for purposes of the case that this time would generally be compensable under the FLSA, but argued it was noncompensable under its CBA. Section 203(o) of the FLSA provides that unions and employers may bargain over whether "time spent in changing clothes… at the beginning or end of each workday" will be compensated. 29 USC §203(o). The union argued Section 203(o) did not apply because the time spent donning and doffing the gear was not "changing clothes." The district court held the activities constituted changing clothes, and any time spent donning or doffing non-clothing items was de minimis. The U.S. Court of Appeals for the Seventh Circuit affirmed.

In a unanimous opinion authored by Justice Antonin Scalia, the Supreme Court affirmed. It looked to dictionaries from the era of the enactment of Section 203(o) and found that "clothes" constitute items that are "both designed and used to cover the body and are commonly regarded as articles of dress." The court rejected plaintiffs' argument that "clothes" does not include protective items, but also rejected defendant's argument that "clothes" was broad enough to include anything worn on the body. The court noted that under its definition, accessories and tools are not clothes.

In 'United States v. Quality Stores,' the Supreme Court held that in most cases, severance payments constitute wages under the Federal Insurance Contributions Act and are therefore subject to withholding taxes.

Plaintiffs also argued that they had not "changed" clothes, as many employees wore the work clothes over their street clothes. The court rejected this argument, holding that "changing" does not necessarily connote substitution and can also mean altering one's dress. The court stated plaintiffs' argument would lead to unpredictable results as the applicability of Section 203(o) would depend on whether an employee decided to wear his work clothes over street clothes.

The court agreed with the Seventh Circuit that glasses, ear plugs and a respirator are not "clothes." However, it held the de minimis doctrine, which federal courts have applied to donning and doffing claims for small periods of time, "does not fit comfortably within the statute at issue here." Instead, the court directed courts to ask "whether the period at issue can, on the whole, be fairly characterized as time spent in changing clothes or washing." If so, the time qualifies under Section 203(o).

The holding is limited, as the court was addressing only the validity of a CBA which provided that time spent changing clothes was not compensable time. It does not address the issue of whether such time is compensable under the FLSA for a non-unionized work force. Still, the court's approach to the definitions of "clothes" and "change," and its critique of the de minimis doctrine, may impact non-unionized employees' donning and doffing claims.

Severance Taxable

In *United States v. Quality Stores*, 134 S.Ct. 1395 (2014), the Supreme Court held that in most cases, severance payments constitute wages under the Federal Insurance Contributions Act (FICA) and are therefore subject to withholding taxes.

Quality Stores terminated employees in connection with its Chapter 11 bankruptcy and offered the employees severance packages. Quality Stores treated the severance as wages, paying and withholding taxes required under FICA, but subsequently sought a refund. When the Internal Revenue Service neither allowed nor denied the refund, Quality Stores initiated proceedings in Bankruptcy Court. The Bankruptcy Court granted summary judgment to Quality Stores, and the district court and Sixth Circuit affirmed, holding severance does not constitute wages under FICA. However, the Sixth Circuit relied not on FICA's definition of wages but on its interpretation of Section 3402(o) of the Internal Revenue Code, a provision governing income-tax withholding.

The Supreme Court unanimously reversed the Sixth Circuit's decision in an opinion authored by Justice Kennedy. The court started with the proposition that the definition of wages under FICA is broad, and includes "all remuneration for employment." It reasoned that severance payments are necessarily "for employment," as severance is not paid to non-employees and the amount of the payments, like other employee benefits, are frequently tied to years of service and the employee's position. The court also found the broad definition is reinforced by the specificity of FICA's lengthy list of exemptions, such as the exemption for severance payments made because of retirement for disability, and stated such exemptions would be unnecessary were severance payments generally not considered wages.

The court's decision in *Quality Stores* resolves a circuit split created by the Sixth Circuit, as the Federal, Third and Eight Circuits had previously held severance payments constitute wages subject to FICA taxes. The court's holding confirms that in most situations, severance payments should be treated as wages subject to withholdings.