1996

Employment Discrimination: Recent Developments in the Supreme Court

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Recommended Citation
Available at: https://digitalcommons.tourolaw.edu/lawreview/vol12/iss2/9

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Leon Lazer:

Our next speaker on the rather important case involving employment discrimination is one of the leading professors here at Touro and her interest in not only employment discrimination but in other discrimination has resulted in her being well recognized. She has lectured at the various seminars conducted for the education and training of judges and, of course, she is a regular at these conferences of ours. So I want to introduce to you now to deal with employment discrimination our own Eileen Kaufman.

Eileen Kaufman:*

Thank you, Leon. I am going to be talking actually about two employment discrimination cases, one having to do with the use of after-acquired evidence of misconduct and the other that arises in a tax context. That case is Commissioner of Internal Revenue v. Schleier.¹ Although it is not included in your material, it is a very important case dealing with the taxability of awards under discrimination statutes.

For those of you who were here last year, I think you may remember a case that we previewed rather extensively at that time, and that is McKennon v. Nashville Banner Publishing Co.² That was the major employment discrimination case of the term, and it dealt with the issue of after-acquired evidence. More specifically, the issue in the case was whether an employee’s claim of discriminatory discharge is barred when, after that discriminatory discharge, the employer discovers evidence that would have warranted the discharge of the employee for legitimate nondiscriminatory reasons.

Christine McKennon worked for the same company for approximately thirty years. When she turned sixty-two, she was discharged, and she suspected that the termination was based on age. She thereupon brought an action in federal court under the Age Discrimination in Employment Act, hereafter ADEA, seeking backpay as well as reinstatement. However, while her case was pending, in fact, during her deposition, the employer discovered that before she was terminated, she had copied certain confidential documents regarding the company's financial condition. She explained that she did that because she feared that she was about to be fired based on her age, so she copied the documents as "insurance" or "protection." Upon learning of that conduct, the employer promptly sent her a letter again terminating her employment based on this misconduct. Two key facts were not in dispute by the time the case reached the Supreme Court: first, that McKennon’s discharge was actually based on unlawful age discrimination: and, second, that the act of copying the confidential documents would have warranted and actually resulted in her discharge had it been known earlier.

In a unanimous decision, somewhat surprising given the split in the circuits on this issue, the Supreme Court held that after-acquired evidence of misconduct does not bar the discrimination claim. The Court explained that any contrary result would undermine the purpose of discrimination statutes, namely to provide compensation to victims of discrimination and to deter acts of discrimination. In other words, the remedial scheme of antidiscrimination statutes would be undermined if after-acquired


5. Id.
6. Id. at 884.
evidence of wrongdoing operated to preclude discrimination claims.\textsuperscript{7}

However, that does not mean that after-acquired evidence has no role to play. It does indeed have a role to play when it comes to the specific remedy to be ordered. While the Court declined to fashion a bright line rule to be applied in every case, the Court did provide some general guidelines. As a general proposition, reinstatement and front pay are inappropriate because those remedies would unduly interfere with the legitimate interest that employers have in not having to rehire someone who had committed the kind of misconduct that warranted dismissal.\textsuperscript{8} On the other hand, backpay is an appropriate remedy, at least from the date of the unlawful discharge to the date that the employer discovered the evidence of the misconduct.\textsuperscript{9} While offering these as general guidelines, the Court also indicated that the lower courts should consider what the Court called “extraordinary equitable circumstances” in fashioning the appropriate scope of relief in the particular case.\textsuperscript{10}

It should be clear that McKennon places the burden on the employer in the first instance to demonstrate that the misconduct was so severe that (a) it would have warranted dismissal, and (b) it would actually have resulted in dismissal.\textsuperscript{11} However, the Court did not impose an additional burden on employers to demonstrate that, absent the discrimination lawsuit, it actually would have discovered this evidence. McKennon had argued in her brief to the Supreme Court that the Court should impose this

\textsuperscript{7} Id. at 886. “Congress designed the remedial measures . . . to serve as a ‘spur or catalyst’ to cause employers to ‘self-examine and to self-evaluate their employment practices and to endeavor to eliminate, so far as possible, the last vestiges’ of discrimination.” Id. at 884. The Court found that “[a]n absolute rule barring any recovery . . . would undermine the ADEA’s objective of forcing employers to consider and examine their motivations, and of penalizing them for employment decisions that spring from age discrimination.” Id.

\textsuperscript{8} Id. “It would be both inequitable and pointless to order reinstatement of someone the employer would have terminated . . . .” Id.

\textsuperscript{9} Id.

\textsuperscript{10} Id.

\textsuperscript{11} Id.
as an additional element of proof because of the potential for abuse. \(^{12}\) Remember how the evidence was discovered in *McKennon*; it was discovered during discovery in the discrimination suit. In fact, that is typically how the evidence of misconduct is acquired. \(^{13}\) We talked a little bit last year at this conference about the fact that employers were becoming increasingly aggressive in seeking out, through discovery, evidence of misconduct so that they could minimize potential liability. The *McKennon* Court acknowledged that potential for abuse, \(^{14}\) but indicated that the availability of fee shifting and the availability of sanctions under Rule 11 \(^{15}\) would operate as sufficient safeguards against that type of abuse. \(^{16}\)

While *McKennon* is an age discrimination claim, there is little doubt that the decision is equally applicable to other federal antidiscrimination statutes. The Court specifically located the ADEA within the wider antidiscrimination statutory scheme. \(^{17}\) Thus, not surprisingly, the *McKennon* ruling has been applied to Title VII cases and to claims arising under § 1981 and § 1983. \(^{18}\)

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13. See, e.g., Wallace v. Dunn Constr. Co., 968 F.2d 1174 (1992). In *Wallace*, the employer learned during the employee's deposition in the litigation that the employee had pled guilty to "possession of cocaine and marijuana prior to her filing her application for employment" upon which she indicated she had never been convicted of a crime. *Id.* at 1176-77. See also *supra* note 19 and accompanying text.


17. *Id.* at 884. The Supreme Court noted that "[t]he ADEA and Title VII share common substantive features and also a common purpose: 'the elimination of discrimination in the workplace.'" *Id.* (citation omitted).

18. *See* Russell v. Microdyne Corp., 65 F.3d 1229 (4th Cir. 1995). The court relied upon the reasoning in *McKennon*, which "made clear that its analysis applied not only to claims under the ADEA, but to those under Title VII as well." *Id.* at 1238; Mardell v. Harleysville Life Ins. Co., 65 F.3d 1072, 1973 (3d Cir. 1995) (finding that the court was bound by *McKennon* in a Title VII action); Wehr v. Ryan's Family Steak House, Inc., 49 F.2d 1150, 1153
One interesting issue that has arisen post-McKennon is how to handle cases involving misconduct at the time of the initial hiring. Those cases tend to be resume fraud cases and misstatements on employment applications, particularly, misstatements about whether or not the applicant has a college degree.\(^\text{19}\) The question under McKennon is whether the employer should have to prove that it would have fired the employee upon learning of the resume fraud or whether it would suffice for the employer to say and prove that it would not have hired the employee had it known of the resume fraud.

The Fifth Circuit recently concluded that the standard is “whether the employee would have been fired upon discovery of the wrongdoing, not whether he would have been hired in the first instance.”\(^\text{20}\) The court explained, “Merely asking whether the employee would have been hired fails to recognize that an employer may retain an individual who has performed successfully despite lack of formal qualification.”\(^\text{21}\) However, there are some other decisions that apparently would preclude reinstatement and front pay upon a finding either that the

\(^{19}\) See, e.g., Russell v. Microdyne Corp., 65 F.3d 1229, 1234 (4th Cir. 1995) (during discovery the employer learned that there were false representations made on the employee’s resume regarding her work experience); Shattuck v. Kinetic Concepts, Inc., 49 F.3d 1106 (5th Cir. 1995), infra note 20 and accompanying text.

\(^{20}\) Shattuck v. Kinetic Concepts, Inc., 49 F.3d 1106, 1108 (5th Cir.). In Shattuck, the employee brought an action for unlawful discharge under the ADEA. Just prior to the commencement of the trial, the employer discovered that the employee “falsely represented on his employment application that he was a college graduate when in fact he had completed less than a year of college work.” Id. The employer argued that they never would have hired him if they knew from the beginning that he was not a college graduate, and “would have fired him upon its discovery.” Id. The court held that the employer “cannot obtain the relief it seeks solely on account of its after-acquired evidence.” Id.

\(^{21}\) Id. at 1109.
employee would have been fired or that he or she would not have initially been hired.22

A slight variation of this issue that has been raised post-
McKennon is whether the McKennon doctrine applies to cases where the misconduct occurs after discharge. At least one court has held that McKennon is not applicable to that type of fact pattern.23

Finally, let me briefly make a few practical points about litigation post-McKennon. First, the McKennon doctrine has resulted in the fairly routine denial of motions for summary judgment.24 I think that reflects the fact that under McKennon, there is likely to be a factual question concerning whether the

22. Mardell v. Harleysville Life Ins. Co., 65 F.3d 1072, 1073 (3d Cir. 1995) (misrepresentations on employee’s resume and job application regarding background information such as professional experience and educational degrees); Wallace v. Dunn Constr. Co., 968 F.2d 1174, 1176-77 (11th Cir. 1992) (misrepresentation on job application that employee had never been convicted of a crime). In Wallace, the court stated that reinstatement and front pay would go beyond making the employee “whole” and would “unduly” limit an employer’s freedom to discharge unqualified and/or untrustworthy employees. Id. at 1182. See also Massey v. Trump’s Castle Hotel and Casino, 828 F. Supp. 314, 317 (D. N.J. 1993) (misrepresentation on employee’s job application that he left his prior employment “for personal reasons when in fact he was forced to resign because of a sexual harassment claim”). The court in Massey held that after-acquired evidence which demonstrates that the employer would have terminated the employee anyway will bar remedies such as front-pay and reinstatement, but that such evidence will not preclude employee seeking alternative remedies such as backpay. Id. at 324.

23. See Carr v. Woodbury County Juvenile Detention Center, 905 F. Supp. 619 (N.D. Iowa 1995). Carr involved an employee’s post-employment use of marijuana. The employer cited this practice as grounds for her termination after such information was acquired. Id. at 621. The court held, however, that such after-acquired evidence was not admissible because there was no proof that the employee used controlled substances during her employment nor was there any reason to believe that she would have used drugs had her employment continued. Id. at 628-29. Moreover, in support of its finding that McKennon was not applicable under these facts, the court stated that “[c]ounty policies governing employment simply cannot properly, . . . either legally or equitably, be imposed upon a person after his or her employment has terminated. Id. at 629.

employer would have fired the employee for this type of misconduct. Given the factual issues and given the fact that equitable considerations now have a role to play in fashioning the relief, summary judgment is likely to be inappropriate. The second practical point that I would like to make is that, given McKennon, bifurcation of the discrimination claim may be sensible, because under McKennon, the evidence of misconduct has no relevance to the liability phase of the case. It is only relevant with respect to the relief that is ordered, and so it may be appropriate to bifurcate the trial so as not to let evidence of the misconduct be improperly used in the liability phase.

The second employment discrimination case decided last term is the tax case that I mentioned, Commissioner of Internal Revenue v. Schleier.25 The issue in that case was whether an award under the ADEA constitutes taxable income.26 I do not claim to be a tax expert, but I think I can explain this case relatively simply. Let me provide just a little bit of background. First, the Internal Revenue Code very broadly defines gross income as “all income from whatever source derived . . . .”27 However, § 104(a)(2) excludes from gross income the amount of any damages received on account of personal injuries or sickness.28 Therefore, the issue in Schleier turns on whether an award under the ADEA constitutes damages on account of personal injuries.29

The other piece of background that I think is essential is the 1992 decision of United States v. Burke30 because, there, the Court concluded that an award of backpay under Title VII, the pre-1991 version of Title VII, was not excludable from gross

26. Id. at 2161.
27. I.R.C. § 61(a) (West 1994).
28. I.R.C. § 104(a)(2) (West 1994). Section 104(a)(2) provides in pertinent part that “gross income does not include . . . the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness[.]”
29. Schleier, 115 S. Ct. at 2162.
30. 504 U.S. 229.
income.\textsuperscript{31} That decision rested on the fact that Title VII, prior to 1991, afforded very limited relief -- no compensatory damages, no punitive damages, and no jury trial; rather, only backpay and reinstatement were available.\textsuperscript{32} The Court in \textit{Burke} relied on a regulation of the Treasury Department that interpreted the Internal Revenue Code to exempt only those damages awarded in a tort-type action and, given the limited remedies available under Title VII at the time, the Court had little trouble concluding that Title VII could not be considered tort-like.\textsuperscript{33}

That brings us to \textit{Schleier}, which raises the identical issue but in the context of an age discrimination claim.\textsuperscript{34} The ADEA prohibits discrimination in employment based on age, and provides legal and equitable relief, reinstatement, hiring, and promotion, as well as awards for backpay and an equal award for liquidated damages if the conduct is determined to be willful.\textsuperscript{35} It also provides a right to a jury trial, but it does not authorize compensatory relief in the form of pain and suffering or emotional distress damages.\textsuperscript{36}

The taxpayer in \textit{Schleier} received an award of approximately $145,000 by way of settlement. Half of that was allocated to backpay and half was allocated to liquidated damages. The taxpayer initially included only the backpay in his gross income.\textsuperscript{37} He excluded the liquidated damages portion of the award, but he subsequently filed for a refund, arguing that the entire award under the ADEA should be excludable from gross income.\textsuperscript{38}

\begin{itemize}
\item \textsuperscript{31} \textit{Id.} at 242.
\item \textsuperscript{32} \textit{Id.} at 238.
\item \textsuperscript{33} \textit{Id.} at 241.
\item \textsuperscript{34} \textit{Schleier}, 115 S. Ct. at 2161.
\item \textsuperscript{35} \textit{Id.} at 2162. \textit{See supra} note 3.
\item \textsuperscript{36} \textit{Id.} See \textit{Slatin} v. Stanford Research Institute, 590 F.2d 1292, 1296 (4th Cir. 1979) (reasoning that the purpose of the ADEA is to prevent discrimination on the basis of age and, thus, that the absence of a provision for compensatory damages for pain and suffering within the statute is dispositive of the legislative intent that such remedies are not appropriate); \textit{see also} \textit{Phuong} v. National Academy of Sciences, 901 F. Supp. 12 (D.C. Cir. 1995) (providing that a terminated employee has the right to a jury trial when violations of the ADEA are claimed against a private corporation).
\item \textsuperscript{37} \textit{Id.} at 2162.
\end{itemize}
income.38 The Tax Court agreed, as did the Fifth Circuit.39 In a six to three decision, the Supreme Court reversed, holding that no portion of the ADEA award is excludable from gross income because the award is not on an account of personal injuries.40

To explain its conclusion, although this explanation leaves me a little confused, the Court compared an ADEA claim to a typical automobile accident recovery.41 The Court said in the car accident case, the victim "suffers (a) medical expenses, (b) lost wages, and (c) pain, suffering and emotional distress," and all of those damages are excludable from gross income because each and every element of that award satisfies the statutory requirement that the damages be received "on account of personal injuries."42

In sharp contrast, the Court stated that the ADEA award is not an award on account of personal injury or sickness even though the lost wages that are suffered by the ADEA plaintiff might look very much like the lost wages of the car accident victim.43 The Court acknowledged that an unlawful termination may cause some psychological or emotional injuries that are similar to the intangible injuries suffered by an automobile accident victim, but the Court concluded that the recovery of back wages is simply not attributable to that injury.44 It is the absence of causation between the personal injury and the lost wages that is dispositive to the majority. The Court explained

thus, in our automobile hypothetical, the accident causes a personal injury which in turn causes a loss of wages. In age

38. Id.
40. Schleier, 115 S. Ct. at 2167. Justice Stevens delivered the opinion of the Court, in which Justices Rehnquist, Kennedy, Ginsburg and Breyer joined. Justice Scalia concurred in the judgment. Justice O'Connor wrote a dissenting opinion, in which Justice Thomas joined and in which Justice Souter joined with respect to Part II. Id.
41. Id. at 2163-64.
42. Id.
43. Id. at 2164.
44. Id. at 2163-64.
discrimination, the discrimination causes both personal injury and loss of wages, but neither is linked to the other. The amount of back wages recovered is completely independent of the existence or extent of any personal injury.\textsuperscript{45}

If you are having trouble distinguishing the car accident case from the age discrimination case, you are in good company. In a very sharply worded dissent, Justice O'Connor criticized the majority for seemingly backing off from its earlier pronouncement that discriminatory treatment does inflict a personal injury and that the damages received on account of that are received on account of personal injury within the meaning of the Internal Revenue Code.\textsuperscript{46}

However, getting back to the majority opinion, in addition to finding that backpay is not excludable from gross income, the Court also held that liquidated damages are not excludable from gross income.\textsuperscript{47} The Court rejected the argument advanced by the plaintiff that liquidated damages are meant to be compensatory, that they are meant to compensate for trivial sorts of damages that are hard to quantify.\textsuperscript{48} The Court relied on a 1985 decision, \textit{Trans World Airlines v. Thurston},\textsuperscript{49} where the Court had characterized liquidated damages under the ADEA as punitive in nature and given that, like back wages, liquidated damages are not received on account of personal injury, and, therefore are not excludable from gross income.\textsuperscript{50}

I think the most significant part of the \textit{Schleier} decision is the Court's rejection of the argument based on the Treasury regulation which interprets § 104(a)(2) of the Code to apply to damages received "through prosecution of a legal suit or action based upon tort or tort type rights . . . ."\textsuperscript{51} That was the analysis

\begin{itemize}
\item \textsuperscript{45} \textit{Id.}
\item \textsuperscript{46} \textit{Id.} at 2167-69.
\item \textsuperscript{47} \textit{Id.} at 2164-65.
\item \textsuperscript{48} \textit{Id.} at 2615.
\item \textsuperscript{49} 469 U.S. 111, 125 (stating that "Congress intended for liquidated damages to be punitive in nature").
\item \textsuperscript{50} \textit{Id.} at 125.
\item \textsuperscript{51} Treas. Reg. § 1.104-1(c) (1994); \textit{Schleier}, 115 S. Ct. at 2165-66.
\end{itemize}
of *United States v. Burke*,

where the Court looked at the statute, Title VII, and said, "Is this a tort type action? Does Title VII create a scheme that appears to be tort-like?" There, the Court said no.\(^5\)

In *Schleier*, the Court rejected the argument that the ADEA is tort-like.\(^5\) That is surprising because in *Burke*, what the Court focused on were two characteristics of tort-like actions: (1) The availability of punitive damages, and (2) the availability of a jury trial. Both were present under the ADEA. The *Schleier* Court says that is not sufficient. The real hallmark of a tort-like action is the availability of full compensatory relief, compensation for things like pain and suffering and emotional distress. In the absence of that, we do not have a tort-like action.\(^5\) The second basis for rejecting the taxpayer's regulatory argument, and this is the one I think will have the most impact on subsequent cases, was the Court's conclusion that the treasury regulations cannot stand as a substitute for the statutory requirement.\(^5\) The Treasury Department cannot issue a regulation that says that so long as the damages are recovered in a tort-like action, they are excludable from gross income because the Internal Revenue Code itself says, and requires, that the damages must be received on account of personal injuries.\(^5\)

Therefore, the upshot of *Schleier* is that in order for damages to be excludable, the awards must satisfy two independent requirements: (1) It must have been received through litigation of a tort-type action, and, (2) it still must be on account of personal injuries.\(^5\) I think that raises a whole host of very interesting

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52. 504 U.S. 229, 237 (1992). "In order to come within the § 104(a)(2) income exclusion, [the taxpayer] must show that Title VII, the legal basis for their recovery of backpay, redresses a tort-like personal injury in accord with [the statutory language limiting the exclusion to cases involving physical injury or sickness]." *Id.*

53. *Id.* at 237-41.


55. *Id.* at 2167.

56. *Id.*


questions. First and foremost, of course, is its effect on Title VII now that Title VII has been amended. Title VII now provides the right for a jury trial, and provides for compensatory and punitive damages.\(^{59}\) Under *United States v. Burke*, I think that most of us thought that damages under Title VII as amended would now be excludable. However, *Schleier* clearly indicates that establishing the cause of action as tort-like is not sufficient.\(^{60}\) The taxpayer has to additionally demonstrate that the recovery is on account of personal injury or sickness,\(^{61}\) and if age discrimination does not qualify, it is very hard to imagine that race or sex discrimination would. I suspect that damages awarded under Title VIII, the Fair Housing Act, would fare no better.

The results under § 1983. I think, are a little more complicated. I suspect that the decision in *Schleier* calls into question several § 1983 reported decisions, decisions which held that § 1983 damages were excludable from gross income.\(^{62}\) However, I think that the result depends on the basis of the § 1983 claim being asserted. If you have a § 1983 claim involving a discharge on First Amendment grounds, I think that looks like a discrimination claim and I think those damages are not going to be excludable. However, a § 1983 claim of excessive force strikes me as fundamentally different, involving as it does, tangible physical injury.

Finally, what about punitive damages under *Schleier*? I suspect that punitive damages would not be excludable from gross income as the Fourth,\(^{63}\) Fifth,\(^{64}\) the Ninth,\(^{65}\) the Tenth\(^{66}\) and


\(^{60}\) *Schleier*, 115 S. Ct. at 2167.

\(^{61}\) *Id*.

\(^{62}\) *See*, e.g., Wulf v. City of Wichita, 883 F.2d 842 (10th Cir. 1989); Bent v. Commissioner, 835 F.2d 67 (3d Cir. 1987).

\(^{63}\) *See* Commissioner v. Miller, 914 F.2d 586, 590 (4th Cir. 1990) (stating that punitive damages were not excludable from gross income because they did not serve the statutory purpose of "mak[ing] the taxpayer whole from a previous loss of personal rights . . . .").

\(^{64}\) *See* Estate of Moore v. Commissioner, 53 F.3d 712 (5th Cir. 1995); Robinson v. Commissioner, 70 F.3d 34 (5th Cir. 1995); Wesson v. United States, 48 F.3d 894 (5th Cir. 1995).
Federal Circuit have held. Only the Sixth Circuit has treated punitive damages as excludable. There is an added complication, one not even discussed in Schleier, and that is in 1989, the Internal Revenue Code was amended to state that § 104(a)(2) shall not apply to any punitive damages in connection with a case not involving a physical injury or physical sickness. Presumably, that means if the punitive damages are ordered in a case involving personal injury or a physical injury or physical sickness, they would be excludable. That was not even discussed in Schleier. In some way, it seems to fly in the face of Schleier, but that certainly would have to be taken into account.

I leave you with one final thought. Once you determine whether or not the award is taxable, what, if anything, do you say to the jury about that? If you decide that the award is not taxable, should the jury be told that? There is considerable authority — and if anyone is interested in it, I will be glad to supply it after the lecture — that juries should be told, that juries are so tax conscious that if you do not tell them, they will inflate the award on that basis, so a cautionary instruction should be given. Thank you very much for your attention.

65. See Hawkins v. United States, 30 F.3d 1077 (9th Cir. 1994); Roemer v. Commissioner, 716 F.2d 693 (9th Cir. 1983).
67. See Reese v. United States, 24 F.3d 228 (Fed. Cir. 1994).
68. See Horton v. Commissioner, 33 F.3d 625 (6th Cir. 1994). In reaching its decision on this point, the court reasoned that the proposition "[t]hat money damages make the injured person whole is merely a legal fiction." Id. at 632. The court, therefore, "follow[ed] the directive of the Supreme Court and the Sixth Circuit" and focused upon "the nature of the claim underlying [the taxpayer's] damages award." Id. at 630. Accordingly, the court found the taxpayers "damages -- both compensatory and punitive -- were received 'on account of' their personal injuries . . ." and, consequently, were excluded from gross income. Id.