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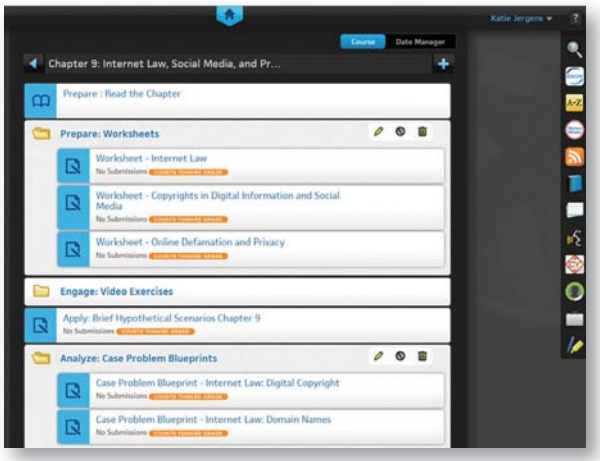

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ARTICLES

REGULATION OF WORKPLACE GOSSIP: CAN EMPLOYERS MITIGATE POTENTIAL LIABILITY WITHOUT VIOLATING THE NLRA?[*]

by

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INTRODUCTION

It's little surprise that employers attempt to regulate workplace gossip. Popular business literature portrays gossip as eroding employee cohesion and discipline, wasting time and creating a poisonous work environment.[1] Influential organizations from the Roman Catholic Church[2] to the U.S. Chamber of Commerce[3] advocate regulating gossip. In the United States, employers may be liable for gossip under common law or various statutory theories.[4] Regulating workplace gossip may seem prudent business strategy. However, in a recent case before the National Labor Relations Board (NLRB, or "Board"), one employer's no-gossip policy was found to violate the National Labor Relations Act (NLRA

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[*]Material in this paper was presented to the 2014 North East Academy of Legal Studies in Business annual meeting under the title, "Follies and Pitfalls of Attempting to Regulate Workplace Gossip: Protected Concerted Activity Meets *Prosocial* Gossip."

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or "the Act").[5] Can an employer mitigate potential liability for workplace gossip without violating the NLRA?

This paper explores how employers can regulate workplace gossip without violating the Act. We examined NLRB decisions considering both gossip-specific work rules and broader work rules involving speech related conduct.

EMPLOYER REGULATION OF WORKPLACE GOSSIP

Research in the U.S. and Western Europe shows that more than 90% of the workforce engages in some form of gossip.[6] Meanwhile, gossip has morphed from being shared at the physical "water cooler" to the virtual one with emails, texts, instant messages, tweets, and social media status updates. Employers have reacted to workplace gossip with everything from consciousness-raising sessions [7] to regulation and outright employment terminations.[8]

Gossip regulation is found in diverse industries and workplaces. A Montana-based online printing company requires its new hires to sign a written "no gossip" provision embedded in an *agreement to values*.[9] At UNESCO gossip is included in the anti-harassment policy under *moral harassment*.[10] Wal-Mart has disciplined and fired employees for *spreading rumors,*[11] and *gossip mongering*.[12]

There is clustering of regulation in certain industries, such as healthcare, where this language is popular:

> We will not engage in or listen to negativity or gossip. We recognize that listening without acting to stop it is the same as participating.[13]

Firms big and small regulate gossip. Empower, a boutique public relations firm in Chicago has a mandatory, "no

gossip" policy,[14] as does Bridgewater Associates, one of the world's largest hedge funds.[15]

Some employers discipline or discharge workers for gossip under the at-will employment doctrine[16] or ad-hoc work rules. Our research demonstrates that employers regulate gossip through a variety of general work rules from anti-harassment rules to wage nondisclosure rules.[17]

LAW AND THE REGULATION OF GOSSIP

An extensive, yet highly porous, web of laws enmeshes workplace speech. The applicable laws often depend upon whether the employer is governmental or private sector. The First Amendment[18] and the NLRA provide the backbone of speech protection; state laws may afford additional rights. Legal status also may derive from how the speech is communicated; for example, in instances of speech via email or social media, the Stored Communications Act[19] might apply. Common law concepts such as defamation also apply to workplace speech. Workplace gossip may fall into any of these legal regulatory schemes, even if the speech takes place outside the workplace.

This paper focuses on liability under the National Labor Relations Act. Therefore the analysis is limited to private employers in the United States that are subject to the jurisdiction of the National Labor Relations Board.[20] The NLRA applies to the vast majority of private sector employees – both union and non-union – even though they may not be conscious of their rights under the Act, and their employers may not realize that the labor law applies to their type of organization; indeed, a common misunderstanding is that the NLRA applies only to unionized workplaces.[21]

Is Gossip protected concerted activity?

Does the NLRA guarantee the right to gossip about work? Section 7 of the NLRA grants "employees" the right to engage in "concerted activities" for "mutual aid or protection."[22] *Employee* is broadly defined to include both unionized and nonunionized workers in the private sector; however it does not include "supervisors." [23] It is "...an unfair labor practice for an employer to interfere with, restrain, or coerce employees..." with regard to exercise of their Section 7 rights.[24] The terms *concerted activities* and *mutual aid and protection* are not defined specifically within the Act.

The NLRB has interpreted protected concerted activity as generally requiring two or more employees acting together toward an improvement in working conditions; however, a single employee may act alone on behalf of others.[25] A substantial question is whether the benefit or improvements sought would inure to the individual solely or to the group as a whole.[26] Individual griping is not protected under the Act.[27]

In previous work[28] we noted that while some workplace gossip could be considered mere "idle talk" or "chatter," and some may be harmful and malicious, gossip may "constitute preliminary activity toward mutual aid and protection that would constitute protected, concerted activity" under Section 8(a)(1) of the NLRA. We determined that gossip most likely would be considered protected concerted activity when it can be construed as relating to "terms and conditions of employment,"[29] or "matters affecting … employment,"[30] is more than "griping,"[31] and involves discussion with other employees.[32] Not all gossip is protected. [33] We have noted that gossip can be so "opprobrious" that it loses protection of the Act. [34]

Overly broad no gossip policy violates the NLRA

In the first case to consider a stand-alone no gossip policy under the NLRA, an administrative law judge ruled that the policy violated Section 8(a)(1) of the Act.

In 2012 an Atlanta-area for-profit school, Laurus Technical Institute ("Laurus"), [35] instituted a "No Gossip Policy" and subsequently terminated admissions representative Joslyn Henderson, based in part on violations of the new gossip policy.[36] The Acting General Counsel[37] issued a complaint against Laurus for unfair labor practices for maintaining an overly broad "No Gossip Policy" and for suspending and terminating Henderson for violating the "No Gossip Policy" while engaged in protected concerted activities.[38]

The Laurus policy defined *gossip* as:

1. Talking about a person's personal life when they [sic] are not present
2. Talking about a person's professional life without his/her supervisor present
3. Negative, or untrue, or disparaging comments or criticisms of another person or persons
4. Creating, sharing, or repeating information that can injure a person's credibility or reputation
5. Creating, sharing, or repeating a rumor about another person
6. Creating, sharing or repeating a rumor that is overheard or hearsay…[39]

The policy also discussed gossip in terms of draining productivity and morale.[40] Henderson's termination apparently followed a period of upheaval in the organization.[41] Henderson

verbally objected to new enrollment goals and how admissions "leads" were handled – behavior the administrative law judge characterized as protected.[42]

Judge Dawson noted that the policy would prohibit communications – positive or negative – outside the presence of the subject and his or her supervisor.[43] The judge opined that such a policy – on its face – would "chill" an employee's lawful activity under the Act and would be viewed to do so by a reasonable employee. She found the no gossip policy violates section 8(a)(1) of the Act[44] and added:

> Indeed, [Laurus] does not even defend the no gossip rule in its brief. The language in the no gossip policy is overly broad, ambiguous, and severely restricts employees from discussing or complaining about any terms and conditions of employment.[45]

Laurus appealed Judge Dawson's decision to the full board, but did not attempt to defend its no-gossip policy on appeal, vigorously defending the case on other grounds.[46] The Board accepted Judge Dawson's finding that the no-gossip policy was over broad and violated the NLRA,[47] ordering the employer to rescind its policy and to offer the plaintiff reinstatement.[48]

Regulating gossip after Laurus

As we expected, the Board adopted the ALJ's decision in *Laurus* with respect to the no-gossip policy violating Section 8(a)(1) of the NLRA.[49] Thus, we strongly caution employers about banning gossip as broadly and generally as Laurus did.

There is, however, a category of gossip that falls outside the protection of the NLRA. It is well established that gossip that is specifically *malicious* is not protected,[50] and this principle recently was extended to gossip that is *harmful*.[51] The precise language of the rule is important; the Board makes a distinction between banning "malicious gossip," which is allowed, and banning "malicious statements," which is not.[52] The Board has found a work rule prohibiting engaging and listening to "negativity or gossip" violated Section 8(a)(1) of the Act,[53] so we caution about linking an otherwise lawful ban on malicious or harmful gossip with other work rules.

What workplace speech can be regulated under the NLRA?

Employers are understandably concerned about the organization's liability for hostile work environment or harassment-type claims stemming from gossip.[54] Legal concerns and a real or perceived decrease in productivity[55] may motivate employers to enact anti-gossip policies. The NLRA may be the furthest thing from the employer's mind, if the employer even is aware of the labor law.[56] The legal concerns surrounding harassment certainly are legitimate. While approving a work rule prohibiting *abusive or threatening language* under the Act the court in *Adtranz* noted, "[u]nder both federal and state law, employers are subject to civil liability should they fail to maintain a workplace free of racial, sexual, and other harassment."[57]

If no gossip policies are risky, are there other regulatory approaches less likely to violate the NLRA?[58] We examined more than 45 speech related work rules on which the Board has ruled. The Appendix presents our findings which illustrate that nearly 72% of these speech related work rules were found to violate the NLRA.

The Board applies a multi-part test to assess whether a speech related work rule violates the Act. The initial step asks, "...whether the rule explicitly restricts activities protected by Section 7."[59] If explicit restriction is not evident, a workplace rule still may violate Section 8(a)(1) if any *one* of these are true.

(1) employees would reasonably construe the language to prohibit Section 7 activity;
(2) the rule was promulgated in response to union activity; or
(3) the rule has been applied to restrict the exercise of Section 7 rights.[60]

Examining the work rules found to pass the test, there is an extreme end of the spectrum consisting of harassing and abusive behavior. The Board has approved work rules banning:

- Abusive and threatening language[61]
- Profane language[62]
- Harassment[63]
- Verbal, mental and physical abuse[64]
- Injurious, offensive, threatening, intimidating or coercive conduct[65]
- Slanderous statements[66]
- Oral or written statements, gestures, or expressions that convey a direct or indirect threat of physical or emotional harm[67]

At the other end of the spectrum, the Board has very recently approved banning displays of "negative attitude" to staff or guests of the firm in one instance.[68] We caution that this new precedent on "negative attitude" may not be entirely reliable.[69]

GOSSIP AND SOCIAL MEDIA IN THE WORKPLACE

In a recent survey nearly 90% of businesses reported using social media for business purposes and 80% of those reported having social media policies for their employees.[70] It is increasingly likely that an employer's work rules regarding speech and its social media policy will intersect. [71] If an employer includes provisions in its social media policy regarding discussions between or among employees it should consider whether those provisions might violate the Act.[72] An NLRB Regional Director noted, "[t]he conduct at the water cooler is now sometimes the conduct in the social media, but the same law applies."[73] This echoes a statement by Board Chairman Pearce recently where he explained the role of the NLRB as, "... applying traditional rules to a new technology."[74] As the law develops we note the fluid nature of the virtual water cooler where workers can interact and share work-related information easily with others outside the workplace - a feature not found around the water cooler in traditional workspaces.[75]

Recently in *Kroger Co.,* [76] an administrative law judge struck down a social media policy with a rule that prohibited discussion of matters such as plant closings – which are protected by Section 7 of the Act.[77] The ALJ also struck down Kroger's rule regarding confidentiality of "personnel matters" because it was not defined or limited.[78]

PRACTICAL IMPLICATIONS FOR MANAGERS

At the outset we noted that gossip often is viewed as eroding discipline, wasting time and creating a toxic work environment.[79] We noted that workplace gossip also has the

potential for employer legal liability; the focus of this paper has been a strategy for the mitigation of that legal liability. As Constance Bagley has stressed, managers should use the law in ways that create value for the firm.[80] Attempts to regulate workplace gossip – particularly if the regulation is overly broad – are more likely to result in hindering value rather than creating value for an organization. We have demonstrated that there are ways to implement work rules that mitigate an employer's potential liability without violating the NLRA. Beyond rules that encompass harassment and other serious behaviors, we add a note of caution. When an employer attempts to use work rules to enforce a *civility code* in the workplace, it may find itself incurring significant attorney's fees defending its rules before the Board.[81]

Taking another view, gossip can be a positive, proactive, management tool. Gossip has been shown to have potential for exposing workplace wrongdoing, and as such it can play an important role in reinforcing ethics and legal compliance. For example, we note the potentially useful role of gossip in exposing workplace wrongdoing. One of the largest corporate scandals of the twentieth century, which led to the downfall of the ENRON Corporation, was initially brought to light through office gossip.[82] Corporate compliance programs often prevent misconduct or mitigate sanctions in the event misconduct is uncovered.[83] We note that in a workplace where gossip is banned, reporting may be delayed or ignored and it might take longer for wrongful conduct and unethical practices to "surface" for corrective action.

CONCLUSION

Gossip is so central to the human psyche that it is virtually impossible to eliminate.[84] Moreover, based on the affirmation of the *Laurus*, decision, it is likely that a broad anti-gossip provision would chill employees' rights to

protected concerted activity. Employers who wish to regulate harmful workplace speech without running afoul of the NLRA should craft their work rules to include precise definitions of the speech prohibited, such as "malicious or harmful gossip," "abusive and threatening language," "profane language," "harassment," "verbal, mental and physical abuse," "bullying or other injurious, offensive, threatening, intimidating or coercive conduct."

We recommend that employers recognize that not all gossip is created equal. Some of it has positive value. As noted by eminent management scholar, Henry Mintzberg,

> ...today's gossip may be tomorrow's fact. The manager who is not accessible for the telephone call informing him that his biggest customer was seen golfing with his main competitor may read about a dramatic drop in sales in the next quarterly report. But then it's too late.[85]

Rather than attempting to ban all workplace gossip, managers should use gossip as a diagnostic tool for issues that management can solve at the root level.[86] Grosser et al. suggest that ideally, employers should "reduce all of the destructive and unnecessary forms of gossip while allowing the positive and functional forms of gossip to remain."[87] We agree and believe this approach also will find legal support under the NLRA.

Appendix: Survey of speech related work rules examined by the NLRB, 1979-2014			
Speech related work rules ≠rule prohibiting.	***Violates NLRA Section 8(a)(1) ?***		***Authority***
Abusive language: abusive/threatening language≠		NO	[88]
Abusive language: profane language, harassment verbal/mental/physical abuse≠		NO	[89]
Complaining: about conditions of employment≠	YES		[90]
Confidentiality: information such as personal/financial≠	YES		[91] [92]
Confidentiality: disclosing confidential information	YES		[93]
Confidentiality: wages, discipline, performance ratings	YES		[94]
Confidentiality: divulging company-private information≠		NO	[95]
Confidentiality: not discuss internal investigations	YES		[96]
Confidentiality: not discuss work-related accidents	YES		[97]
Courtesy: be courteous, polite & friendly, respectful	YES		[98]
Derogatory attacks≠	YES		[99]
Disclaimer requirement: employees required to use a specified disclaimer identifying themselves as an associate	YES		[100]
Disciplinary action: discussion of≠	YES		[101]
Discourteous or inappropriate attitude or behavior	YES		[102]
Disrespectful conduct≠	YES		[103]
Disruptive conduct≠	YES		[104]
Disparaging comments≠	YES		[105]
False statements≠	YES		[106]
False, vicious or malicious statements≠	YES		[107] [108] [109]
Oral, written statements, gestures/expressions, direct/indirect threat of physical or emotional harm		NO	[110]
Gossip: indulging in harmful gossip≠		NO	[111]
Gossip: malicious≠		NO	[112] [113] [114]
Gossip: broad no gossip policy	YES		[115]
Gossip: gossiping about others inc supervisors/managers		NO	[116]
Gossip: will not engage in or listen to negativity or gossip	YES		[117]
Gossip & complaining/general prohibition	YES		[118]
Grievances: limits on discussion of grievances≠		NO [119]	[120]

Harassment: of employees, supervisors≠		NO	[121]
Injurious, offensive, threatening, intimidating, coercing≠		NO	[122]
Negativity: displays of negative attitude disruptive≠		NO	[123]
Negativity: negative comments fellow team members≠	YES		[124]
Negativity: negative conversations employees/managers≠	YES		[125]
Non-Disparagement	YES		[126]
Posting/circulating/distributing writing w/o permission	YES		[127]
Rumor: commenting on rumors, speculation, or personnel matters, rumors or speculation related to business plans ≠	YES		[128]
Slander: slanderous or detrimental statements≠		NO	[129]
Social media policy: broad confidentiality policy + do not post anything false, misleading, obscene, defamatory, profane, discriminatory, libelous, threatening, harassing, abusive, hateful or embarrassing to person or entity.	YES		[130]
Social media policy: inappropriate behavior online≠	YES		[131]
Social media policy: sharing of personal information about employees such as performance and compensation≠	YES		[132]
Social media policy: may not blog, enter chat rooms, post messages on public websites, disclose company info	YES		[133]
Social media policy: use of social networking sites that could discredit company or damage its image≠	YES		[134]
Social media policy: statements damaging or that defame≠	YES		[135]
Unauthorized information in reference requests≠		NO	[136]
Terms and conditions of employment: discuss w/clients≠	YES		[137]
Unfair criticism: Verbal comments or physical gestures directed at others that exceed the bounds of fair criticism≠	YES		[138]
Wages: wage and salary non-disclosure rule	YES		[139] [140] [141] [142]

[1] Rosemary Hartigan and Paula O'Callaghan, *Loose Lips Bring Pink Slips: Fired for Gossip at the Office*, 40 *ACAD. LEGAL STUD. IN BUS. NAT'L PROC.* __,24 (2009). Available at http://alsb.roundtablelive.org/Default.aspx?pageId=619644.

[2] Francis X Rocca, *Be 'conscientious objectors' to gossip Francis urges curial officials.* CATHOLIC HERALD. December 23, 2013, http://www.catholicherald.co.uk/news/2013/12/23/be-conscientious-objectors-to-gossip-francis-urges-curial-officials/

[3] The US Chamber of Commerce Foundation asks, "Is Gossip Poisoning Your Workplace?" and prescribes a three-step treatment plan, of which the

first step is creating a "no-gossip" policy http://institute.uschamber.com/is-gossip-poisoning-your-workplace/

[4] See, Reese v. Barton Healthcare Systems, 693 F. Supp. 2d 1170 (E.D. Cal. 2010) (Employer may be responsible under *respondeat superior* for defamatory statement made by one employee about another if made within the scope of employment); See also, Adtranz v. NLRB, 253 F.3d 19, 27 (Ct. Appeals DC Cir, June 26, 2001). ("Abusive language can constitute verbal harassment triggering liability under state or federal law")

[5] See, Laurus Technical Institute, NLRB No. 10-CA-093934 (Div. of Judges, December 11, 2013), *aff'd*, Laurus Technical Institute, 360 NLRB, No. 133 (2014), Laurus Technical Institute v. NLRB, No. 14-1139 and 14-1162 (D.C. Cir, In Mediation), briefs and docket information available at http://nlrb.gov/case/10-CA-093934

[6] Travis J. Grosser, Virginie Lopez-Kidwell, Giuseppe (Joe) Labianca, and Lee Ellwardt, *Hearing it Through the Grapevine: Positive and Negative Workplace Gossip,* ORGANIZATIONAL DYNAMICS, 41 (2012), 52-61 at 53.

[7] SAM CHAPMAN, THE NO-GOSSIP ZONE: A NO-NONSENSE GUIDE TO A HEALTHY, HIGH-PERFORMING WORK ENVIRONMENT (2009), 26.

[8] See, for example, Letner v. Wal-Mart, 172 F.3d 873, 1999 U.S. App. LEXIS 843 (6th Cir. Tenn. 1999).

[9] Shayla McKnight, *Workplace gossip? Keep it to yourself,*. N.Y.TIMES, November 15, 2009, at BU9, *available at* http://www.nytimes.com/2009/11/15/jobs/15pre.html.

[10] UNESCO, Standards of Conduct, Anti-harassment Policy, http://www.un.org/womenwatch/osagi/UN_system_policies/(UNESCO)Anti-harassment_Policy.pdf

[11] Rumors can be about people or events; gossip is about people who are not present (see, for example, Grosser, et.al. *supra* note 6).

[12] See, Jackson v. Ritter, 1992 U.S. Dist. LEXIS 12114 (1992), *aff'd*, 990 F.2d 1268 (11th Cir. Ala. 1993) (Wal-Mart employee disciplined for malicious gossip); State ex rel. Wal-Mart v. Riley, 159 Ohio App. 3d 598 (Ohio Ct. App., 2005) (Wal-Mart employee fired for spreading rumors).

[13] See, for example, Community Memorial Hospital, Hicksville, OH http://www.cmhosp.com/printpage/index.cfm?pageID=10 (Behavior Standards; Attitude); Madison County Healthcare System, Winterset, Iowa http://www.madisonhealth.com/Main/CompassofIntegrity.aspx (Attitude); and Illini Community Hospital, Pittsfield, IL http://www.illinihospital.org/?id=392&sid=3 (Behavioral Standards).

[14] CHAPMAN, *supra* note 7, at 11.

[15] John Cassidy, *Mastering the Machine, How Ray Dalio built the world's richest and strangest hedge fund.* THE NEW YORKER, July 25, 2011, http://www.newyorker.com/reporting/2011/07/25/110725fa_fact_cassidy?currentPage=all; See also, John Crace, *The office that banned gossip.* THE GUARDIAN, July 5, 2010, http://www.theguardian.com/theguardian/2010/jul/05/office-banned-gossip

[16] See, NLRB v. RELCO Locomotives, Inc., 734 F.3d 764, (8th Cir., 2013), (employer fired two employees for spreading a "malicious rumor" – later determined to be protected concerted activity).

[17] See, Appendix, survey of speech related work rules examined by the NLRB, 1979-2014.

[18] See, Jerome O'Callaghan, Rosemary Hartigan, and Paula O'Callaghan, (Spring 2011). *Gossip, the Office and the First Amendment.* 25 NORTH EAST J. OF LEG STUD, 1-20

[19] 18 U.S.C. 121 §§ 2701–2712.

[20] See, jurisdictional standards, http://www.nlrb.gov/rights-we-protect/jurisdictional-standards

[21] John R. Runyan and Mami Kato, *What Every Employment Lawyer Needs to Know About the National Labor Relations Act*, MICHIGAN BAR J. (September, 2013), p. 34, https://www.michbar.org/journal/pdf/pdf4article2260.pdf

[22] 29 U.S.C. §§ 157.

[23] 29 U.S.C. §§ 152.

[24] 29 U.S.C. §§ 158(a)(1). Remedies could involve reinstatement and back pay. 29 U.S.C. § 157 (10)(160)(c).

[25] See, Meyers Industries (I), 268 NLRB 493, 497 (1984); and Meyers Industries (II), 281 NLRB 882, 887 (1986).

[26] NLRB v Talsol Corp, 155 F3d 785, 796 (6th Cir. 1998).

[27] Mushroom Transp. Co. v. NLRB, 330 F.2d 683, 685 (3rd Cir. 1964).

[28] Paula O'Callaghan and Rosemary Hartigan, Do Bans on Workplace Gossip Violate the NLRA? Employers Respond to Employee Speech in the Social Media Age, 43 *Acad. Legal Stud. In Bus. Nat'l Proc.* __ (2012). Available at http://alsb.mobi/wp-content/uploads/2012/04/NP-2012-OCallaghan_Hartigan.pdf

[29] *Id.* at 7. See, Knauz BMW. This decision was vacated for procedural reasons by NLRB v. Noel Canning, 134 S. Ct. 2550 (2014).

[30] *Id.* See, Hispanics United of Buffalo. This decision was vacated for procedural reasons by Noel Canning, *supra* note 29.

[31] *Id.* at 9.

[32] *Id.* at 8. See, discussion of Knauz BMW case.

[33] O'Callaghan and Hartigan, *supra* Note 28 at 3, "malicious gossip."

[34] O'Callaghan and Hartigan, *supra* Note 28 at 9, citing *Atlantic Steel* test.
[35] Laurus Technical Institute, *supra* note 5 at 10.
[36] *Id.*
[37] The Acting General Counsel will be referred to as the "General Counsel."
[38] Laurus, *supra* note 5 at 10-11.
[39] *Id.* at 4
[40] "Gossip is not tolerated at Laurus Technical Institute. Employees that participate in or instigate gossip about the company, an employee, or customer will receive disciplinary action. Gossip is an activity that can drain, corrupt, distract, and down-shift the company's productivity, moral [sic], and overall satisfaction. It has the potential to destroy an individual and is counterproductive to an organization. Most people involved in gossip may not intend to do harm, but gossip can have a negative impact as it has the potential to destroy a person's or organization's reputation and credibility…" Ibid.
[41] *Id.* at 5. See, "Mass Firings."
[42] *Id.* at 7. See, "New admissions director and workplace changes."
[43] *Id.* at 12.
[44] *Id.*
[45] Laurus, *supra*, note 5 at 12.
[46] Laurus argued that it had sufficient other grounds to terminate Henderson's employment, that the NLRB lacked a quorum to act on this case, and challenged the impartiality of the administrative law judge in the case. See, Brief in Support of Exceptions filed 1/8/2014, available at http://www.nlrb.gov/case/10-CA-093934
[47] Laurus Technical Institute, 360 NLRB, No. 133 (2014) at 1 (see, footnote 1 within Board decision and order).
[48] Judge Dawson inadvertently neglected to order that the plaintiff be reinstated *Id.* (see, footnote 2 within Board decision and order).
[49] Note that Laurus did not seriously defend the no gossip policy before the Board. See, Brief in Support of Exceptions, available at http://www.nlrb.gov/case/10-CA-093934 Laurus appealed to the Court of Appeals for the D.C. Circuit, its brief made no mention of the no gossip policy. See, Brief to Court of Appeals, available at http://www.nlrb.gov/case/10-CA-093934 On December 30, 2014 Laurus posted a "Notice to Employees" by order of the NLRB, stating the company would "not maintain or enforce any overly broad no-gossip policy or rule...not discipline [employees]...for violating the overly broad no-gossip policy...We will...rescind our no-gossip policy..." Compliance Case - Certification of Posting, available at http://nlrb.gov/case/10-CA-093934 This case currently is held in abeyance by the Court of Appeals pending

completion of a mediated settlement between Laurus and the NLRB. See, Laurus Technical Institute v. NLRB, No. 14-1139 and 14-1162 (D.C. Cir,, In Mediation). Circuit Court Order available at http://nlrb.gov/case/10-CA-093934

[50] Southern Maryland Hosp. Ctr., 293 NLRB No. 136 (1989), enfd. in rel. part, 916 F.2d 932 (4th Cir. 1990); Sam's Club, 342 NLRB No. 57 (2004); and Ellison Media Company, 344 NLRB No. 136 (2005).

[51] See, Hyundai America Shipping Agency, 357 NLRB No. 80 (2011).

[52] See, Lafayette Park Hotel 326 NLRB No. 69, at 825 (1998) and American Cast Iron Pipe Co., 234 NLRB No. 178, at 1126 (1978), *enf'd* 600 F.2d 132 (8th Cir. 1979).

[53] Hills and Dales General Hospital, 360 NLRB No. 70 (2014) at 1, *appeal docketed*, No.14-1082 and 14-1119, Hills and Dales General Hospital v. NLRB (D.C. Cir., November 7, 2014). General Counsel did not allege that the prohibition on gossip was unlawful.

[54] O'Callaghan and Hartigan, *supra*, note 28 at 2.

[55] Howard M. Wexler and Joshua D. Seidman, More Talk for the Water Cooler – NLRB Judge Finds Employer's "No Gossip Policy" Unlawful, SEYFARTH SHAW LLP LABOR RELATIONS BLOG, available at http://www.employerlaborrelations.com/2013/12/26/more-talk-for-the-water-cooler-nlrb-judge-finds-employers-no-gossip-policy-unlawful/.

[56] *Id*.

[57] Adtranz v. NLRB, *supra* note 4 at 27. See also, Eugene Volokh, *What Speech Does "Hostile Work Environment" Harassment Law Restrict?* 85 GEO. L.J. 627 (1997).

[58] Kecia Bal, *Goodbye, No-Gossip Policies*, (May 13, 2014), HUMAN RESOURCE EXECUTIVE ONLINE, http://www.hreonline.com/HRE/view/story.jhtml?id=534357081

[59] Flex Frac Logistics v. NLRB, 2014 U.S. App. LEXIS 5429 (5th Cir., 2012), *aff'd*, 746 F. 3d 205 (5th Cir., 2014), quoting Lutheran Heritage Village-Livonia, 343 NLRB No. 75, at 646 (2004).

[60] FlexFrac quoting Heritage Village-Livonia at 647.

[61] Adtranz v. NLRB, *supra* note 4.

[62] Adtranz v. NLRB, *supra* note 4, and Lutheran Heritage Village-Livona, *supra*, note 59 at 647 (It was noted that in a workplace where the use of profane language is commonplace such a restriction may be unlawful).

[63] Lutheran Heritage Village-Livona, *supra*, note 59 at 647.

[64] *Id*.

[65] Palms Hotel and Casino, 344 NLRB 1363 (2005).

[66] Tradesmen International, 338 NLRB No. 49 at 463 (2002).

[67] First Transit Inc., 360 NLRB No. 72 (2014).

[68] Copper River of Boiling Springs, LLC, 360 NLRB No. 60 at 1 (2014) (employee was discharged for a verbal outburst using a profanity).
[69] See, David Weldon, *Luck of the (Panel) Draw? NLRB Narrowly Upholds Employer's Negative Attitude Rule* (March 5, 2014), http://www.franczek.com/frontcenter-NLRB_Copper_River_Boiling_Springs.html#page=1.
[70] SOCIAL MEDIA IN THE WORKPLACE AROUND THE WORLD 3.0, PROSKAUER ROSE, LLP (2013/2014), at 1-2, available at http://www.proskauer.com/files/uploads/social-media-in-the-workplace-2014.pdf
[71] See generally, Robert Sprague and Abigail E. Fournier, *Online Social Media and the End of the Employment at-Will Doctrine*, 52 WASHBURN L. J. 557-579 (2013), and Steven Greenhouse, *Even If It Enrages Your Boss, Social Net Speech Is Protected*, N.Y. TIMES, January 21, 2013, http://www.nytimes.com/2013/01/22/technology/employers-social-media-policies-come-under-regulatory-scrutiny.html?pagewanted=all.
[72] See, Christine Neylon O'Brien, *The National Labor Relations Board: Perspectives on Social Media*, 8 CHARLESTON L. REV. 411-428 (2014).
[73] Rosemary Pye, *The 21st Century Water Cooler: Applying the NLRA to Social Networking and Beyond*, https://www.northeastern.edu/law/pdfs/alumni/labor-law-2012.pdf.
[74] Steven Greenhouse, *supra*, note 71.
[75] Ariane Ollier-Mallaterre, Nancy Rothbard and Justin Berg, *When Worlds Collide In Cyberspace: How Boundary Work In Online Social Networks Impacts Professional Relationships*, 38 ACAD. OF MGMT. REV. 4, 645 (2013).
[76] The Kroger Co. of Michigan, Case No. 07–CA–098566, (Division of Judges, April 22, 2014) at 14.
[77] *Id*. at 15.
[78] *Id*.
[79] Rosemary Hartigan and Paula O'Callaghan, *supra*, note 1 at 24.
[80] See, CONSTANCE E. BAGLEY, WINNING LEGALLY: HOW TO USE THE LAW TO CREATE VALUE, MARSHAL RESOURCES, AND MANAGE RISK 37 (2005).
[81] Also reinstatement and/or back pay. See, 29 U.S.C. § 157 (10)(160)(c).
[82] Adam H. Gates, *Enforcing Civility in the Workplace is a Potentially Risky Proposition, According to the NLRB*, May 15, 2014, available at http://www.bakerdonelson.com/enforcing-civility-in-the-workplace-is-a-potentially-risky-proposition-according-to-the-nlrb-05-15-2014/

[83] Jonathan Sack, *When is an Internal Investigation Not Privileged?* FORBES, April 16, 2014, available at http://www.forbes.com/sites/insider/2014/04/16/when-is-an-internal-investigation-not-privileged/.
[84] *Supra*. note 6 at 53.
[85] As cited in Grosser et al. *supra* note 6 at at 53-54.
[86] *Id*. at 59.
[87] *Id*. at 56.
[88] Adtranz v. NLRB, *supra* note 4.
[89] Lutheran Heritage Village-Livonia, *supra* note 59 at 647.
[90] Guardsmark, LLC, 344 NLRB No. 97 at 809 (2005).
[91] MCPc, 360 NLRB No. 39 (2014), *appeal docketed*, No. 14-1379 and 14-1731, MCPc, Inc. v. NLRB, (3rd Cir., April 14, 2014).
[92] First Transit Inc., *supra* note 67.
[93] Flex Frac Logistics, *supra* note 59.
[94] DirectTV, 359 NLRB No. 54 (2013). Vacated for procedural reasons by Noel Canning, *supra* note 29. Board is currently considering the case. See, http://nlrb.gov/case/21-CA-039546
[95] Lafayette Park Hotel, *supra* note 52.
[96] Banner Health Systems, 358 NLRB No. 93 at 1 (2012). Decision vacated for procedural reasons by Noel Canning, *supra* note 29. The Board is currently considering the case. See, http://nlrb.gov/case/28-CA-023438
[97] First Transit Inc., *supra* note 67.
[98] Knauz BMW, 358 NLRB No. 164 at 1 (2012).
[99] Southern Maryland Hospital, *supra* note 50.
[100] The Kroger Co. of Michigan, *supra* note 76.
[101] SNE Enterprises, Inc., 347 NLRB 472, 492–493 (2006), enfd. 257 Fed. Appx. 642 (4th Cir. (2007).
[102] First Transit Inc., *supra* note 67.
[103] University Medical Center, 335 NLRB No. 87 (2001), enforcement denied in pertinent part, 335 F.3d 1079 (D.C. Cir. 2003).
[104] Brighton Retail, 354 NLRB No. 62 (2005).
[105] American Medical Response, Case 34–CA–12576, Advice Memorandum dated October 5, 2010.
[106] First Transit Inc., *supra* note 67.
[107] Lafayette Park Hotel, *supra* note 52.
[108] Cincinnati Suburban Press, 289 NLRB No. 127 (1988).
[109] American Cast Iron Pipe Co., *supra* note 55.
[110] First Transit Inc., *supra* note 67.
[111] Hyundai America Shipping Agency, *supra* note 51.
[112] Southern Maryland Hospital, *supra* note 50.

[113] Sam's Club, *supra* note 50.
[114] Ellison Media Company, *supra* note 50.
[115] Laurus Technical Institute, *supra* note 5.
[116] Casino San Pablo, 361 NLRB No. 148 (2014).
[117] Hills and Dales General Hospital, *supra* note 53. With "negativity."
[118] Aroostook County Regional Ophalmology Center v. NLRB, 81 F.3d 209 (D.C. Cir. 1996), aff'd in part and denied in part 317 NLRB No. 32 (1995).
[119] But must consider the organizational context. *Id.*
[120] In a larger hospital setting, same rule might violate Act, *Id.*
[121] Lutheran Heritage Village-Livonia, *supra* note 59.
[122] Palms Hotel and Casino, s*upra*, note 65.
[123] Copper River of Boiling Springs, s*upra*, note 68.
[124] Hills and Dales General Hospital, *supra* note 53.
[125] Claremont Resort & Spa, 344 NLRB No. 105 (2005).
[126] Quicken Loans, 359 NLRB No. 141 (2013), affirmed by 361 NLRB No. 94 (2014), *appeal docketed*, No. 14-1231, Quicken Loans, Inc. v. NLRB, (D.C. Cir., January 7, 2015).
[127] First Transit Inc., *supra* note 67.
[128] The Kroger Co. of Michigan, *supra* note 76.
[129] Tradesmen International, *supra* note 66.
[130] Valero Services, See, http://www.nlrb.gov/news-outreach/news-story/valero-services-agrees-rescind-its-nationwide-social-media-policy and http://www.cookbrown.com/doc.asp?id=693
[131] The Kroger Co, *supra* note 76.
[132] General Motors, NLRB No. 07-CA-53570 (Div. of Judges, Detroit, MI, May 30, 2012).
[133] DirectTV, *supra*, note 94.
[134] Butler Medical Transport, NLRB No. 05–CA–97810 (Div. of Judges, Baltimore, MD, Sept. 4, 2013).
[135] Costco Wholesale Corporation 358 NLRB No. 106, (2010). Vacated for procedural reasons by Noel Canning, *supra* note 29. The Board is currently considering the case. See, http://nlrb.gov/case/34-CA-012421
[136] First Transit Inc., *supra* note 67.
[137] Kinder-Care Learning Centers, 299 NLRB No. 164 (1990).
[138] William Beaumont Hospital, No. 07-CA-093885 (Div. of Judges, Detroit, MI, January 30, 2014).
[139] Design Technology Group, LLC d/b/a Bettie Page, 359 NLRB No. 96 (2013), *aff'd*, 361 NLRB No. 79 (2014), *appeal docketed*, No. 14-1232, Design Technology Group v. NLRB, (D.C. Cir., November 5, 2014)
[140] NLRB v. Brookshire Grocery Company, 919 F.2d 359 (5th Cir., 1990).

[141] DirectTV, *supra*, note 94.
[142] First Transit Inc., *supra* note 67.

Advance Directives Containing Pregnancy Exclusions: Are They Constitutional?

by

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I. INTRODUCTION

Estate planning tends to focus on the distribution of assets and minimization of estate taxes upon an individual's death. While these are important objectives, it is equally important for individuals to plan for the possibility of incompetence. Every state has an advance directive statue that allows individuals to direct their health care in the event they become incompetent. Written into a majority of these statutes is a "pregnancy exclusion" that limits the effectiveness of the advance directive when the patient is a pregnant woman. The effect of the exclusion differs from state to state, and there is virtually no public awareness that pregnancy exclusions exist.

This article analyzes the various pregnancy exclusions and explores whether a state's interest in the fetus should take precedence over a woman's right to refuse or terminate life support.

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II. THE HISTORY OF ADVANCE DIRECTIVES

End-of-life issues have long been the cause of intense debate, focusing on questions concerning patient autonomy, quality of life, and the withholding or withdrawal of life-sustaining treatments. Advances in medical care and technology have blurred the boundaries between life and death and have challenged our expectations about how individuals should experience the end of life. In the 1960s the patient rights movement sought to free terminally ill patients from aggressive and ultimately futile life sustaining treatment.[1] This resulted in the earliest form of advance directive, the living will. Living wills are designed to maintain the patient's "voice" in medical decision making and empower individuals to dictate the terms of their own medical care at the end of life.[2]

Initially it was the states, rather than the federal government, that moved to give legal force to living wills. However there was no uniformity in the state statutes, and they were hard to compare because they often appeared under ambiguous or unrelated titles. The *Uniform Rights of the Terminally Ill Act*[3] *(URTIA)* was drafted in 1985 by the Commissioners on Uniform State Laws to provide guidance to the states. *URTIA* only applies to living wills. Living wills specify the individual's wishes regarding life-prolonging treatment. *URTIA* does not apply to medical proxies, which allow individuals to name a surrogate to make medical decisions on their behalf. Furthermore, *URTIA* only applies when a person is in a terminal condition, not permanently comatose or in a vegetative state.

URTIA states, "Life sustaining treatment must not be withheld or withdrawn pursuant to a declaration from an individual known to the attending physician to be pregnant so long as it is probable that the fetus will develop to the point of live birth with the continued application of life-sustaining treatment."[4] The original *URTIA*, adopted by the conference in 1985, also included the phrase, "unless the declaration otherwise provides" but this phrase was removed and is not in the current provision.[5] It was, therefore, the original intent of *URTIA* to limit statutory pregnancy exclusions only to those cases where a woman's living will did not set forth her wishes in the event she was pregnant when her directions were to be carried out. While some states follow the current *URTIA* model, others do not; state statutes continue to lack uniformity.

After the landmark Supreme Court decision in *Cruzan v. Director, Missouri Department of Health*[6] in 1990, the importance of advance directives became a national issue. Nancy Cruzan remained in a persistent vegetative state after suffering brain damage due to a lack of oxygen from a traumatic car accident, being kept alive by life-sustaining treatment. Her parents wished to discontinue the treatment, testifying that their daughter had previously expressed that she would not want to continue in such a state.[7] The Court found that her parents had not met the required burden of proof of clear and convincing evidence, so the life-sustaining treatment could not be withdrawn.[8] This was the first time the Court recognized that there exists a constitutionally protected right to refuse life-sustaining treatment. In an effort to inform the public of their right to determine the course of their treatment even after they become incompetent, Congress passed the *Patient Self-Determination Act* of 1990.[9] This act requires

medical care providers receiving federal Medicare or Medicaid funds to inform all adult patients of their constitutional right to prepare an advance directive consisting of a living will and/or health care proxy. While the act helps to insure that people are informed of their right to create advance directives, it gives little guidance on the specific information that should be discussed with the patient, and completely fails to mention the existence of pregnancy exclusions.

III. PREGNANCY EXCLUSIONS

Currently thirty-one (31) states have pregnancy exclusions that limit the application of an advance directive if the patient is a pregnant woman. These exclusions can be classified into two categories:

1. Statutes that automatically invalidate a woman's advance directive if she is pregnant; and

2. Statutes that invalidate a pregnant woman's advance directive only if the fetus is viable and/or if the fetus could develop to the point of a live birth.

The policies of the remaining nineteen (19) states plus the District of Columbia can also be classified into two categories::

1. Statutes that allow women to write their own wishes regarding pregnancy into their advance directives, and guarantee that their instructions will be followed; and

2. States were the law is silent with regard to advance directives and pregnancy.

State laws make it clear that the rights of a pregnant woman vary greatly depending upon the state in which she is receiving treatment.

AUTOMATIC INVALIDATION OF ADVANCE DIRECTIVE

Currently twelve (12) states have statutes that automatically invalidate a woman's advance directive if she is pregnant. These states are: Alabama[10], Connecticut[11], Idaho[12], Indiana[13], Kansas[14], Michigan[15], Missouri[16], South Carolina[17], Texas[18], Utah[19], Washington[20], and Wisconsin[21]. These states have the most restrictive pregnancy exclusion statutes. They require that pregnant woman be placed on or continue receiving live-sustaining treatment, regardless of the progression of the pregnancy, until she gives birth. None of these statutes makes an exception for patients who will be in prolonged severe pain that cannot be alleviated by medication, or those who will be physically harmed by continuing life-sustaining treatment. It appears that these states place the interest of the unborn child above those of the mother.

Having an advance directive does not guarantee that a person's wishes will be followed, but it makes allowing death less controversial. Both health care providers and family members are more likely to know exactly what the dying person wants. In general, even if there is no legal advance directive, life support can be removed if the health care team and family members all believe that it is the right course of

action for the dying person. This rule, however, does not apply if that person is a pregnant woman.

The New York Times published an article about 33-year-old Marlise Munoz, who collapsed on her kitchen floor from what appeared to be a blood clot in her lungs. Marlise and her husband, Erick, were the parents of a toddler, and Marlise was 14 weeks pregnant with their second child at the time she collapsed.[22] Doctors at the Fort Worth, Texas, hospital pronounced her brain dead and her family confirmed that she did not want her body to be kept alive by machines. Hospital officials argued, however, that state law required them to maintain life-sustaining treatment for a pregnant patient, and refused to discontinue treatment.

Marlise did not leave any written directives regarding end-of-life care. But Erick Muñoz had no doubt concerning what his wife wanted. They were both paramedics, and it was something they had talked about many times. Long before she was hospitalized her husband and parents had made Marlise a promise to honor her wishes, and they were determined to keep it.[23] The family filed a lawsuit in the 96th District Court in Tarrant County, Texas, requesting that Marlise's life support be removed.

At the time of the hearing Marlise was 22 weeks pregnant. The hospital acknowledged that she had been brain dead for eight weeks and the fetus she carried was not viable. The judge sided with the family, ordering the hospital to remove any artificial means of life support from Marlise.[24] The hospital did not appeal, and stated that they had kept Marlise

on life support because they believed they were following the demands of the state statute.

Although the Court's decision allowed the termination of Marlise's life support, it did little to alter the interpretation or application of the Texas statute. The judge's ruling was based on the fact that Marlise Munoz had been declared "brain dead" by the hospital.[25] Since she was legally dead, she was no longer a "patient" whom the hospital was required to treat, and therefore the statue did not apply to her. If instead Marlise had been in a coma or persistent vegetative state, the hospital would have been required by law to continue life-sustaining treatment.

INVALIDATION IF A LIVE BIRTH COULD RESULT

Nineteen (19) of the thirty-one (31) pregnancy exclusion states have statutes requiring that life-sustaining treatment be administered to a woman who is known to be pregnant if the fetus is viable and/or if the fetus could develop to the point of a live birth with the continuation of treatment: Alaska[26], Arkansas[27], Colorado[28], Delaware[29], Florida[30], Georgia[31], Illinois[32], Iowa[33], Kentucky[34], Minnesota[35], Montana[36], Nebraska[37], Nevada[38], New Hampshire[39], North Dakota[40], Ohio[41], Pennsylvania[42], Rhode Island[43], and South Dakota[44].

These states could be further classified as follows: Twelve (12) states (Alaska, Colorado, Delaware, Florida, Kentucky, Montana, Nebraska, Nevada, Ohio, Pennsylvania, Rhode Island, and South Dakota) require that it is "probable" or there is a "reasonable degree of medical certainty" that

continued treatment will result in a live birth. These states follow the *URTIA* model. The remaining seven (7) states (Arkansas, Georgia, Illinois, Iowa, Minnesota, New Hampshire and North Dakota) call for continuing treatment when the fetus is "viable", or if it is "possible" that the fetus could develop to the point of a live birth.

There are five (5) states (Kentucky, New Hampshire, North Dakota, Pennsylvania and South Dakota) that stipulate that an exception may be made if continuing treatment will be "physically harmful" to the woman or prolong "severe pain" which cannot be alleviated by medication.

While statutes falling into this category are less harsh then those that automatically invalidate a pregnant woman's advance directive, her expressed wishes will still be ignored if a live birth could result. Also, as previously stated, only five (5) states consider the physical well-being of the mother when deciding whether to continue treatment; the remaining fourteen (14) states focus solely upon the fetus's development and survival.

Turning back to the Munoz case, what if Marlise Munoz had not been declared brain dead? Under Texas's statute the continuation of life support would have been required. This is true even though the hospital acknowledged that the fetus was not viable and suffered from hydrocephalus (an abnormal accumulation of fluid in the cavities of the brain) as well as a possible heart problem and deformed lower extremities[45]. Regardless of the fact that in all probability the fetus would not have survived until birth, or would have died

shortly after birth, the Texas hospital would be required to continue life-sustaining treatment. This would not be true if Marlise was receiving treatment in one of the nineteen (19) states that considered whether a live birth was likely before continuing treatment.

STATUTES THAT ALLOW WOMEN TO WRITE THEIR OWN WISHES REGARDING PREGNANCY

Five (5) states clearly allow women to write their wishes regarding pregnancy into their advance directives and guarantee their instructions will be followed: Arizona[46] Maryland[47], New Jersey[48], Oklahoma[49] and Vermont[50]. These statutes give a woman control over her body under all circumstances and protect her rights as a patient. Moreover, they inform women that a pregnancy could complicate the execution of their advance directive, a fact of which most women are unaware, and provide women with an avenue to assure that their wishes are followed.[51]

The language in the statutes passed in these five (5) states is explicit and expressly requires a woman to consider whether she would choose to continue life support to sustain an existing pregnancy, or terminate life support despite the pregnancy.

STATES WERE THE LAW IS SILENT WITH REGARD TO ADVANCE DIRECTIVES AND PREGNANCY

The remaining fourteen (14) states, plus the District of Columbia, do not address pregnancy in their advance directive statutes. These states are: California, Hawaii, Louisiana,

Maine, Massachusetts, Mississippi, New Mexico, New York, North Carolina, Oregon, Tennessee, Virginia, West Virginia and Wyoming. In these states it may be left to the courts to determine how to proceed. Since going through the court system takes significant time, a pregnant woman may be forced to endure prolonged treatment before the provisions of her advance directive can be carried out.[52] Furthermore, the majority of these states have "conscience clauses," which allow medical professionals or institutions to opt out of withholding life-sustaining treatment if the direction to withhold treatment is contrary to a policy of the medical professional or institution.[53]

VI. STATISTICAL FINDINGS

In this section we will analyze the pregnancy laws by region. First let us introduce some abbreviations that will be used throughout this section:

AIAD = Automatic Invalidation of Advance Directive – 12 states

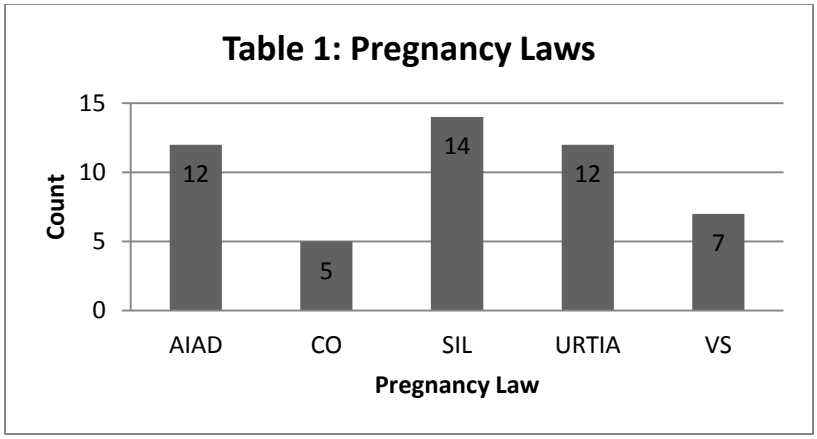
URTIA = Uniform Rights of the Terminally Ill Act– 12 states

VS = Viable Status – 7 states

ILB = Invalidation if Live Birth can Result = URTIA and VS – 19 states

CO = Clear Options – 5 states

SIL = Law is Silent– 14 states



In Table 1 we see that the CO (Clear Options) statute for pregnancy issues only exists in 5 states. In 10% of the states a woman can clearly articulate her wishes regarding pregnancy and these wishes will be guaranteed. In contrast, we see that in Table 1 the laws that are in the group called SIL (Law is Silent) are the most common choice among the states. Hence in 28% of our states if a pregnancy issue comes to light then this matter will be settled in the court system.

A natural comparison to make with Pregnancy Laws is the Region that a state lies in. It would be reasonable to assume the region might have impact on which law a state uses for pregnancy issues. In Table 2 we see that in the Midwest region the majority of states, 5/12 = 41.7%, use AIAD; this means that in the Midwest region many of the states have statutes that automatically invalidate a woman's advance directive if she is pregnant. Additionally, if you add the Midwest and the Southern regions together then you have 2/3 = 66% of the states that use AIAD. Correspondingly, none of the states in the Midwest region follow the CO or SIL laws. It is

also interesting to see that in the Northeast and Western region 4/7 = 57.1% of these states use the SIL option and so any pregnancy issues will be decided by the court system. These statistics point to a clear connection between region and views on pregnancy laws.

Table 2 : Pregnancy Laws by Region						
	Pregnancy Laws					
Region	**AIAD**	**CO**	**SIL**	**URTIA**	**VS**	**Grand Total**
Midwest	5	0	0	3	4	12
Northeast	1	2	3	2	1	9
South	3	2	6	3	2	16
West	3	1	5	4	0	13
Total	12	5	14	12	7	50

V. CONCLUSION

Why would states pass laws prohibiting the removal or withholding of life support from pregnant women? One reason is that states may be concerned that, when the woman indicated her wishes regarding life support, she did not anticipate that she would be pregnant at the time her wishes were to be carried out.

It is possible pregnancy exclusions were enacted to represent the actual intent of the woman had she thought about the situation in advance. Many rights and obligations arise by operation of law when individuals fail to set forth their wishes. Nevertheless this is a weak argument. States could easily include

language in their statutes requiring women to indicate their wishes in the event they are pregnant. Five states already have statues that do just that, thereby providing clear and convincing evidence of the woman's wishes. If all states incorporated such language into their statues, pregnancy exclusions could be limited to those cases where the woman's wishes cannot be adequately determined.

The Supreme Court recognized the right to refuse life-sustaining treatment in *Cruzan*[54]. The right of anyone, pregnant or not, to refuse or terminate life support is a fundamental right. No matter how beneficial a treatment might be for the patient, she still has the right to refuse it. It follows that the government may not compel a person to receive unwanted medical treatment in order to promote the interests of another person, even if that "person" is the woman's unborn child. Yet even when the Supreme Court recognizes the existence of a fundamental right, that right is not absolute.

The Supreme Court's decisions in *Roe v. Wade*[55] and *Planned Parenthood of Southeastern Pennsylvania v. Casey*[56] recognize abortion as a fundamental right, but they also recognize that states have an interest in the potential life of the fetus. In *Casey* the Court held that the viability of the fetus is the point at which the states' interest in potential life outweighs the rights of the woman. Once the fetus is viable abortion may be banned unless it is necessary for the preservation of the life or health of the mother. Prior to viability state laws restricting abortion cannot place a "substantial obstacle" in the path of a woman seeking an abortion.[57]

Applying this standard to pregnancy exclusions, those that automatically invalidate a woman's advance directive if she is pregnant, regardless of the progression of the pregnancy, would appear to be unconstitutional. They place the state's interest in a non-viable fetus above the woman's fundamental right to refuse or terminate life support. But is this a proper comparison? Do the standards established in abortion precedents apply? A live woman has an interest in terminating her pregnancy so she can continue living her life unencumbered, but a dying woman enjoys no similar interest.[58] It can be argued that a pregnant woman's right to terminate life support, thereby terminating her own life and the life of her fetus, seems far less compelling than the state's interest in the potential life that resides in the fetus. Unfortunately, until a tragic set of events occur causing a case of this nature to be heard by the Supreme Court, these questions will remain unanswered.

ENDNOTES

[1] Wilkinson, A, N. Wenger, and L. Shurgarman, (2007) *Literature Review on Advance Directives.* Prepared for the Office of the Assistant Secretary of Planning and Evaluation, U.S. Department of Health and Human Services. Available at http://aspe.hhs.gov/daltcp/reports/2007/advdirlr.pdf.

[2] *Id.*

[3] UNIF. RIGHTS OF THE TERMINALLY ILL ACT, 9B U.L.A. (1987) [hereinafter URTIA].

[4] *Id.*

[5] Green, M. and L. R. Wolfe (2012) *Pregnancy Exclusions in State Living Will and Medical Proxy Statutes*. Prepared for the Center for Women Policy Studies.

[6] *Cruzan v. Director, MO Dept. of Health*, 497 U.S. 261 (1990).

[7] *Id* at 265.

[8] *Id.* at 286-287.

[9] Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, §§4206, 4751, 104 Stat. 1388, 1388-115 to -117, 1388-204 to -206 (codified in scattered sections of 42 U.S.C.).

[10] Natural Death Act §4, ALA. CODE §22-8A-4(e) (LexisNexis 1197 & Supp. 2004) (indicating that the advance health care directive of a pregnant patient does not have effect when the doctor knows the patient is pregnant).

[11] An Act Concerning Death With Dignity §5 CONN. GEN. STAT. ANN. § 19a-574 (West 2003) (making the protections of a living will inapplicable to pregnant women).

[12] Natural Death and Medical Consent Act, IDAHO CODE ANN. § 39-4510 (2005) (providing a form that must be used when writing a living will that includes a provision that does not give effect to the directive if the declarant is pregnant, but also allows for the use of an alternate form, as long as all of the elements of the form are included).

[13] Living Wills and Life-Prolonging Procedures Act §11(d), IND.CODE ANN. §16-36-4-8(d) (LexisNexis 1993) (nullifying the effect of a living will declaration by a pregnant patient).

[14] Natural Death Act §3, KAN.STAT.ANN. §65-28, 103(a) (2002) (prohibiting the living will of a pregnant patient, as diagnosed by the attending physician, to be given effect).

[15] Estate and Protected Individuals Code Act of 1998, MICH. COMP. LAWS §700.5507(4)(3) (disallows patient advocate to make a decision to

withhold or withdraw treatment from a patient who is pregnant that would result in the pregnant patient's death).

[16] MO. ANN. STAT. §459.025 (West 1992) (stating that the declaration will have no effect if the patient is pregnant).

[17] Death with Dignity Act §5(B), S.C. CODE ANN. §44-77-70 (2002) (rendering ineffective a pregnant patient's declaration for the entire course of the patient's pregnancy).

[18] TEX. HEALTH & SAFETY CODE ANN. §166.049 (Vernon 2001) (stating that life support cannot be removed from a pregnant patient).

[19] UTAH CODE ANN. §75-2a-123 (2008) (voiding the directive of a pregnant patient to be removed from life support).

[20] WASH. REV. CODE. ANN. §70.122.030(1) (West 2002) (setting forth in the form suggested for living wills a provision that the directive will have no effect if the declarant's physician knows the declarant is pregnant).

[21] WIS. STAT. ANN. §154.07(2) (West 1997 & Supp. 2004) (voiding the declaration of a pregnant patient).

[22] N.Y. Times, Jan 8, 2014, at 1A (city ed.).

[23] *Id.*

[24] N.Y. Times, Jan. 27. 2014, at 9A (city ed.).

[25] *Id.*

[26] Health Care Decisions Act §1, ALASKA STAT. §13.52.055(b)(4) (2004) (prohibiting the living will of a pregnant woman from taking effect if "it is probable that the fetus could develop to the point of live birth if the life-sustaining procedures were provided").

[27] Arkansas Rights of the Terminally Ill Act or Permanently Unconscious Act §6(c), ARK. CODE ANN. §20-17-206 (c) (2000 & Supp. 2003) (prohibiting the living will of a pregnant patient to be given effect if "the

fetus could develop to the point of live birth with continued application of life-sustaining treatmenr").

[28] Colorado Medical Treatment Decision Act §1, COLO. REV. STAT. §15-18-104(2) (2004) (prohibiting a pregnant woman's living will from being given effect if a medical examination shows the fetus to be viable and, to a reasonable degree of certainty, capable of developing to a live birth if the mother is given continued life support).

[29] Delaware Death with Dignity Act §1 DEL. CODE ANN. tit. 16 §2503(j) (2003) (prohibiting life-sustaining treatment from being withdrawn from a pregnant woman if "it is probable that the fetus will develop to be viable outside the uterus with the continued application of a life-sustaining procedure").

[30] 2 FLA. STAT. ANN. §765.113(2) (West 2005) (a surrogate or proxy may not provide consent for withholding or withdrawing life-prolonging procedures from a pregnant patient if the life of the unborn child may, with a reasonable degree of medical probability, be continued indefinitely outside the womb).

[31] GA. CODE ANN. §31-32-8(a)(1) (2001) (treatment preferences have no force and effect if patient is pregnant and the fetus is viable; if fetus is not viable living will must expressly provide for removal from life support).

[32] Illinois Living Will Act§3(c), 755 ILL. COMP. STAT. ANN. 35/3-3(c) (West 1992) (giving the living will of a pregnant woman no effect if the physician determines "it is possible that the fetus would develop to the point of live birth with the continued application of death delaying procedures").

[33] Life-Sustaining Procedures Act §7, IOWA CODE ANN. §144A.6(2) (West 1997) (refusing to give effect to a living will if the patient is pregnant and "the fetus could develop to the point of live birth with continued application of life-sustaining procedures").

[34] Kentucky Living Will Directive Act §5 KY. REV. STAT. ANN. §311.629(4) (LexisNexis 2001) (requiring a pregnant patient to remain on life support regardless of whether she had executed a living will "unless, to

a reasonable degree of medical certainty," the attending physician and one other physician have certified that "the procedures will not maintain the women in a way to permit the continuing development and live birth of the unborn child, will be physically harmful to the woman or prolong sever pain which cannot be alleviated by medication").

[35] Montana Rights of the Terminally Ill Act §12, MONT. CODE ANN. §50-9-106(6) (2004) (Prohibiting life support from being removed from a pregnant patient "so long as it is probable that the fetus will develop to the point of live birth with continued application of life-sustaining treatment").

[36] Rights of the Terminally Ill Act §8(3), NEB. REV. STAT. §20-408(3) (1997) (requiring pregnant patients to remain on life support "so long as it is probable that the fetus will develop to the point of live birth with continued application of life-sustaining treatment").

[37] Uniform Act on Rights of the Terminally Ill §9(4), NEV. REV. STAT. ANN. §449.624(4) (LexisNexis 2005) (requiring pregnant patients to remain on life support if "it is probable that the fetus will develop to the point of live birth with continued application of life-sustaining treatment").

[38] An Act Relative to Living Wills N.H. REV. STAT. ANN. §137-J:5(V)(c) (2010) (Agent cannot withdraw life-sustaining treatment from a pregnant patient unless to a reasonable degree of certainty a medical professional concludes such treatment will not permit the fetus to develop to the point of a live birth or that such treatment will cause the patient physical harm or prolong sever pain that cannot be alleviated by medication).

[39] Health Care Directives §10, N.D. CENT. CODE §23-06.5-09(5) (Supp. 2005) (prohibiting removal of life support from a pregnant woman unless "such health care will not maintain the principal in such a way as to permit the continuing development and live birth of the unborn child or will be physically harmful or unreasonably painful to the principal or will prolong severe pain that cannot be alleviated by medication").

[40] Modified Uniform Rights of the Terminally Ill Act §1, OHIO REV. CODE ANN. §2133.06 (B) (LexisNexis 2010) (requiring that life support not be withdrawn from a pregnant patient unless the attending physician,

"to a reasonable degree of medical certainty", determines "the fetus would not be born alive").

[41] Advance Directive for Health Care Act §5, 20 PA. CONS. STAT. ANN. 5429(a) (West Supp. 2005) (voiding a pregnant woman's health care directive unless it can be determined "to a reasonable degree of certainty" that prolonged life-sustaining measures "(1) will not maintain the pregnant woman in such a way as to permit the continuing development and live birth of the unborn child; (2) will be physically harmful to the pregnant woman; or (3) would cause pain to the pregnant woman which cannot be alleviated by medication").

[42] Rights of the Terminally Ill Act §1, R.I. GEN. LAWS §23-4.11-6(c) (2001) (voiding the declaration of a pregnant patient if "it is probable that the fetus could develop to the point of live birth with continued application of life sustaining procedures").

[43] An Act to Provide for Living Wills §10, S.D. CODIFIED LAWS §34-12D-10 (2004) (requiring life sustaining treatment to continue for pregnant patients with directives unless, "to a reasonable degree of medical certainty," the attending physician and one other physician determine that "such procedures will not maintain the woman in such a way to permit the continuing development and live birth of the unborn child or will be physically harmful to the woman or prolong severe pain which cannot be alleviated by medication").

[44] N.Y. Times, Jan. 27. 2014, at 9A (city ed.).

[45] ARIZ. REV. STAT. ANN. §36-3262 (2003) (providing the declarant with the option of making specific decisions if she is pregnant).

[46] Health Care Decision Act §2, MD. CODE ANN., HEALTH-GEN. §5-603 (LexisNexis 2005) (providing language in the sample forms that allows for specific instructions should the declarant be pregnant)

[47] Adult Health Care Decisions Act (Minnesota Living Will Act) §13 §1, MINN. STAT. ANN. § 145B (West 2011) (providing that if the patient is

pregnant she can provide specific instructions regarding the continued application of life-sustaining treatment)

[48] New Jersey Advance Directives for Health Care Act §4, N.J. STAT. ANN. §26:2H-56 (West 1996) (permitting "[a] female declarant [to] include in an advance directive executed by her, information as to what effect the advance directive shall have if she is pregnant").

[49] Oklahoma Advance Directive Act, OKLA. STAT. ANN. tit. 63, §3101.8(C) (2006) (pregnant patient will be provided with life-sustaining treatment unless she has specifically authorized that during a course of pregnancy, life-sustaining treatment shall be withheld or withdrawn).

[50] Advance Directive for Health Care and Disposition of Remains, Chapter 231,VT. STAT. ANN. tit 18 §9702(a)(8) (2005) (principal can direct which life sustaining treatment the principal would desire or not desire if the principal is pregnant at the time an advance directive becomes effective).

[51] Green, M. and L. R. Wolfe (2012) *Pregnancy Exclusions in State Living Will and Medical Proxy Statutes.* Prepared for the Center for Women Policy Studies.

[52] *Id.*

[53] *Id.*

[54] *Cruzan v. Director, MO Dept. of Health,* 497 U.S. 261 (1990).

[55] *Roe v. Wade,* 410 U.S. 113 (1973).

[56] *Planned Parenthood of Southeastern Pennsylvania v. Casey*, 505 U.S. 833 (1992).

[57] *Id.* at 877.

[58] Colb, S. F. (2014). *Excluding Pregnant Women from the Right to Terminate Life Support*. Available at: http://verdict.justia.com/2014/01/22/excluding-pregnant-women-right-terminate-life-support#sthash.68ZluS17.dpuf

WATSON V. UNITED STATES – THE FICA TAX DISPUTE CONCERNING WAGES AND DISTRIBUTIONS TO PROFESSIONAL EMPLOYEES/OWNERS

by

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INTRODUCTION

Individuals and businesses seek to avoid the payment of taxes beyond those demanded by the law. In particular, incorporated businesses such as closely held corporations, S corporations, LLCs, PCs and PLLCs reduce their Internal Revenue Code liabilities by distributing their assets as wages to employees. At times, however, the employees of these entities are also shareholders. In estimating and paying tax liabilities, the incorporated businesses may wish to distribute their assets to their employee/shareholders as dividends rather than as wages in order to avoid tax liability for payments of

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Federal Insurance Contribution Act (FICA)[1] taxes and Federal Unemployment Tax Act (FUTA)[2] liabilities upon employee wages. The Internal Revenue Service (IRS) seeks to ensure that the allocation of business distributions as dividends or as wages to employees/owners is reasonable and justified by the Internal Revenue Code and regulations.

Watson v. United States[3] decision typifies the controversy surrounding IRS determinations that corporate taxpayers have underpaid FICA and FUTA tax liabilities by disguising wages as dividend payments or that the dividend payments have been disguised as wages in order to avoid even more onerous corporate taxes.[4]

This article concentrates upon the particular controversy which arises in *Watson* concerning a professional corporation's liability for paying FICA tax upon dividend payments to a professional shareholder-employee who served as the corporation's only director and who authorized the dividend payment to himself when, in fact, a more significant portion of the dividend should have been paid as wages. At the same time, the article examines the entire controversy concerning FICA, FUTA and other tax liabilities for incorporated businesses, particularly closely held businesses, which choose to treat wages as dividends or dividends as wages in order to decrease tax liability. The article concludes that the *Watson* decision correctly determined the liability of the S corporation for FICA tax and warns that proposed legislation setting pre-determined percentages for a professional's wages must be avoided.

THE FICA TAX IS A TAX UPON WAGES

After graduating from college**,** David Watson became a Certified Public Accountant with a Master's Degree in Taxation. In 1996, Watson incorporated his practice as David E. Watson PC (DEWPC) of which he was the sole officer, shareholder, director and employee; DEWPC elected to be taxed as an S corporation. This corporation acted as a partner in the accounting firm of Larson, Watson, Bartling, and Juffer, LLP (LWBJ). LWBJ allegedly had sufficient cash flow to distribute $2000 a month to each partner including DEWPC; DEWPC then authorized a payment of $2000 a month to Watson as his sole wages of $24,000 for the tax years 2002 and 2003. But in addition to his salary Watson, by a DEWPC decision, received $203,651 as profit distributions from LWBJ for 2002 and $175,470 as profit distributions for 2003. The IRS investigated these distributions and determined that at least a portion of the profit distributions from DEWPC to Watson should be treated not as dividends but as wages. The Court of Appeals eventually agreed with the District Court that the reasonable amount of Watson's wages should be set at $91,044 for both 2002 and 2003. The trial court used average billing rates rather than Watson's actual billing rates to determine the wage amount. The appeals court upheld the tax deficiency judgment against DEWPC. The judgment included unpaid employment taxes, penalties and interest amounting to $23,431.33.

IRC section 3121 defines wages as meaning all remuneration for employment including the cash value of all such items including benefits paid in any medium other than cash. As the code regulations indicate,[5] wages include salaries, fees, bonuses, and commissions on sales and on insurance premiums if paid as compensation for employment. The basis upon which remuneration is paid is immaterial and includes a

percentage of the profits,[6] such as the distribution of profits to Watson in this case.

WAGES ARE REMUNERATION FOR SERVICES PERFORMED BY AN EMPLOYEE

Although Watson argued that DEWPC was distributing to him a return on his investment in the accounting incorporated business, the critical FICA tax question concerns whether the statute and facts indicate that at least a portion of the payments made to Watson constituted remuneration for services performed by an employee. The Internal Revenue Code, Section 3121(d) defines an employee as any officer of a corporation or any individual who, under usual common law rules, has the status of an employee.[7] The Court of Appeals cited a series of cases which aided its decision in determining Watson's employee status.

Radtke, S.C. v. United States –Services Actually Rendered Must Be Remunerated As Wages

In *Joseph Radtke, S.C. v. United States*[8]the Court of Appeals for the Seventh Circuit decided that Joseph Radtke S.C. a subchapter S corporation of which attorney Joseph Radtke was its sole shareholder-employee, was subject to Social Security FICA and FUTA taxes upon distributions to him. In the tax year 1982, Mr. Radtke received no salary from the corporation but received $18,225 in dividends for that year. He paid personal income tax on the dividend and the corporation also declared $18,225 on its small business corporation income tax return. The IRS, with the agreement of the District and Appeals courts decided that the dividends were wages subject to FICA and FUTA contributions.[9] Dividends

may not be paid in lieu of compensation for services actually rendered.

Schneider v. Commissioner – Special Scrutiny Cases Include Those in Which Employees Are Also Owners

In cases such as the *Watson* controversy, special and intense scrutiny will be given to distributions where the corporation is controlled by the very employees to whom the distribution is made. Such a lack of arm's length dealing between the corporation and the employee raises suspicion of subterfuge concerning the payment of mandated taxes. In *Charles Schneider & Co. v. Commissioner* [10]the 8th Circuit Court of Appeals faced the other side of the wages/dividends controversy: whether wages paid to employees-shareholders were reasonable and necessary as business deductions for the corporation or dividends subject to more substantial corporate taxation upon the entity's income. The court agreed with the IRS and the United States Tax Court that the wages, including bonuses, paid to the employees-owners were not reasonable and necessary business expenses[11] but were corporate dividends. The court determined deficiency income tax liability against Schneider & Co for the 1966, 1967, and 1968 tax years in the amounts of $23,512.40, $15,333.42, and $21,721.05 respectively. The court also held another allied furniture corporation liable for deficiencies for those tax years in the amounts of $18,130.17, $3,475.46 and $7,365.58.

The facts of this case reveal that Charles Schneider organized a number of furniture and upholstering manufacturing businesses of which he was the sole or principal shareholder. The closely held corporation which Schneider directed permitted distributions to a number of other

shareholders including himself in excess of the normal amounts paid as wages including bonuses to other industry employees. The court noted that several factors helped to determine reasonableness of compensation: the employee's qualifications; the nature of the work, its size and complexity; a comparison of salaried to gross and net business incomes; the prevailing rates of compensation for comparable positions in comparable concerns and the history of compensation paid in previous years. Because this corporation was closely held, special scrutiny of all of these factors resulted in the court's conclusion that the companies paid more wages and bonuses to their employees than other similar businesses and that the payment to some of the employee-shareholders increased even though their workload decreased. The court noted finally that the bonus agreements were governed by corporation bylaws which required the employees to repay their bonuses if they were later declared by a court not to be deductible expenses for tax purposes.[12] It appeared that the corporations' tax counsel had already anticipated a taxability issue.

The Court of Appeals in the *Watson* decision utilized the Schneider reasoning to justify the intense examination of the controversy. DEWPC's distribution to Watson in like manner should be subject to close scrutiny: Watson sought to declare a portion of his wages as his wholly owned corporation's dividends to him, thereby evading FICA liability, but a closer examination of the facts helped to reveal the unjustifiable evasion tactic.

Standard Asbestos v. Commissioner – Case Facts Help to Determine Tax Liabilities

In *Watson* and in all similar controversies, the facts of each case will determine whether payments to a shareholder are compensation for services rendered or distributions of

profits from the business. *Standard Asbestos Manufacturing and Insulating Co. v. Commissioner*[13]once again describes a situation where a closely held corporation was determined to have paid excessive unreasonable salaries to three of its shareholders and that a pension paid to a deceased shareholder's wife was a distribution of profits and not a pension, taxable to her and not deductible by the corporation.

In *Standard*, three brother shareholders solely managed an asbestos manufacturing and insulating business founded in 1918 by their father, whose shares upon his death had passed to his widow, the brothers' mother. During the 1920's and 1930's the Ryder Brother's received wages below the standard for the industry, until about 1937. From this year corporate resolutions substantially increase their wages in order to compensate for previous low salaries. But for the tax years 1949, 1950 and 1951 the corporate resolution in question arranged for bonuses to be paid to the brothers without referring to the fact that they were intended for services rendered in prior years. Pursuant to this resolution, each of the brothers was respectively paid the sums of $52,232.14, $65,290.17 and $65,289.17 during the tax years 1949, 1950 and 1951. The Commissioner of Internal Revenue and U.S. Tax Court then determined that for the 1949, 1950 and 1951 tax years, the sums paid to each of the brothers was in excess of a reasonable amount so that tax deficiencies were assessed against them for any amounts in excess of $42,500.00 for 1949 and $47,500.00 for 1950 and 1951.

The Commissioner and the Court examined extensive evidence concerning the salaries of the brothers paid in prior years. On December 20, 1937 a corporate resolution directed additional payment of wages for the years 1928 to 1930 by raising the compensation by 40%; on January 6, 1941 the salaries of the Ryder brothers were raised to $11,000 because of low salaries paid to them and on January 5, 1942 a corporate

resolution, once again, cited prior low salaries and raised the brothers' waged to $20,000. As already stated, however, the later corporate resolution in question made no mention of prior low salaries.

The percentage of the corporation's net income used to pay the salary bonuses also led the Commissioner and the court to decide that the salaries were unreasonable. In particular, the court noted that the salary bonuses represented a very high percentage of the company's net income during the taxable years, while no other officer of the corporation received more than $9,000.000 in income during the years in question. The court quoted *Builders Steel Co. v. Commissioner*:

> The bonuses given at the end of the year, according to the minutes of the petitioner, were based to a large extent at least upon the earnings that the company had made during the year and its consequent ability to pay. In addition to the fact that there were large earnings resulting to a greater or lesser extent from the efforts of these officers and employees, we cannot escape the thought that the distribution of earnings of the company had the *effect of very substantially reducing the excess profit taxes collectible against the petitioner* [emphasis added]. [14]

The bonuses were used as a subterfuge to avoid properly due corporate taxes.

The salaries paid to competitors in similar businesses additionally convinced the Commissioner and the court of the unreasonableness of the salary bonuses. The president of a competing company offered credible testimony that he received a salary of approximately $16,000.00 in 1949 and approximately $26,000.00 in 1950 and 1951; the court judged his experience and ability to be comparable to that of the tax payer company's officers, the Ryder brothers, and that their activities and hours of work were also quite similar.

In addition, the pension paid to Alice D. Ryder, 84 years old, was not a pension for the founder's widow but a distribution of profits and hence taxable to her. The taxpayer Standard Asbestos Company paid to Alice D. Ryder, the widow of Willard E. Ryder, deceased, the following pension amounts which the company deducted from its taxable income: $20,491.08 in 1949, $32,645.08 in 1950 and $32,645.09 in 1951. The Commissioner and the Tax Court noted that Alice D. Ryder's husband had held 473 ¼ shares of the company's 500 shares of stock before his death but had divided them, among others, to the three Ryder brothers and to his widow. The transfer agreement contained covenants restricting the transfer of the stock, and created a pension for Alice D. Ryder so long as she held the shares and did not re-marry. The agreement contained no references which designated the pension as recognition for the past services of her husband. The Commissioner, the Tax Court and the Court of Appeals reasoned that the pension payments were made for the purpose of assuring control over the stock and would not be deductible business expenses, but would constitute a distribution of profits taxable to Alice D. Ryder. [15]

In regard to the pension paid to Alice D. Ryder, the court noted that the corporate resolutions indicated that the pension was to assure control over the future alienation of shares and was not a deductible business expense but a distribution of profits taxable to the corporation.

Once again, the Court of Appeals used the facts of *Ryder* decision to justify its agreement with the findings of the Commissioner and the Tax Court in the *Watson* controversy. The facts of *Watson* clearly indicate that David Watson received at least a portion of DEWPC's profits as remuneration for wages paid for his services. The $24,000 annual salary

which he received could not at all recompense him for his contributions of skill and work given to the corporation which he himself wholly owned.

THE REASONABLENESS CRITERION FOR DETERMINATION OF EMPLOYEE STATUS AND AMOUNT OF REMUNERATION

The Eighth Circuit Court in *Watson* noted that the Commissioner and the Tax Court had to determine the proper basis for treating David Watson as an employee and the reasonable amount of salary paid to him for the personal services which he actually rendered. Although reasonable compensation usually concerns corporate income tax deduction, a 1974 IRS Revenue Ruling concerning small business corporation dividends paid instead of salaries had stated that the concept applies equally to FICA tax cases.[16] In its ruling, the IRS indicated that the dividend payments of an S corporation constituted wages for FICA tax purposes because the corporation's two shareholder-employees performed reasonably substantial services for the corporation, but received no reasonable wages for those services; in fact no wages at all were paid to them. The Service, in response to the revenue ruling inquiry, concluded that the dividends were paid as reasonable compensation for the reasonably substantial services of those shareholder-employees.

In the *Radtke* controversy mentioned above the attorney sole shareholder of an S corporation also received no salary and the Seventh Circuit Court of Appeals affirmed the conclusions that attorney Radtke had performed reasonably substantial services as an employee of the corporation and that the so-called dividend payments were clearly reasonable remuneration for those services rather than a return of investment to a shareholder.

Veterinary Surgical Consultants, P.C. v. Commissioner[17] in like manner decided that a veterinarian tax payer, the sole shareholder of a professional S corporation, cannot claim that the distributions to him were merely dividends which represented a return on his investment. The Third Circuit Court of Appeals agreed with the Tax Court and Commissioner that a reasonableness criterion must apply to the facts of this case to determine the substantiality of work performed and the wages paid in relationship to that work.

Dr. Kenneth K. Sadanaga practiced veterinary medicine in Pennsylvania during the tax years 1994, 1995 and 1996. Dr. Sadanaga functioned as a full-time employee of Bristol-Myers Squibb Co. during this time and reported wages from the company of $91,212.18 in 1994, $95,851.15 in 1995 and $102,031.14 in 1996; the company withheld the necessary Social Security taxes from his wages. During the same period, however, the Veterinary Surgical Consultants, P.C. S Corporation (VSC) paid to Dr. Sadanaga "non-employee compensation" of $83,995.50 in 1994, $173,030.39 in 1995 and $161,483.35 in 1996. Dr. Sadanaga was VSC's sole shareholder and its only officer. All of VSC's income was generated from the consulting and surgical services performed by Dr. Sadanaga; he was the sole signatory on the corporation's bank account and handled all of its correspondence; he performed substantial services for the corporation working approximately 33 hours a week.

The Tax Court concluded, and the Court of Appeals agreed, that the Commissioner had found overwhelming and certainly reasonable evidence that Dr. Sadanaga performed the entire substance of the work for the corporation and that the distributions in 1994, 1995 and 1996 constituted a reasonable compensation for the veterinarian and were subject to FICA and even FUTA taxes. The Tax Court noted that the form of payments could be but a subterfuge for the reality of their

payment and that the intention of receiving the payments as dividends or distributions of profits had no bearing on the tax treatment of his wages.[18]

The Court of Appeals also agreed with the Tax Court that the 1978 Revenue Act Section 530 safe harbor provisions[19] do not apply to the facts of this case. It is true that VSC did not treat Dr. Sadanaga as an employee for any tax period in question but VSC could not reasonably rely on any of the following three additionally needed exceptions to the rule that Dr. Sadanaga need not be treated as an employee: (a) judicial precedent, published rulings, technical advice or a letter ruling; (b) past IRS order of the taxpayer; or (c) long standing industry practice. The two judicial precedents upon which VSC relied, *Durando v. United States*[20] and *Texas Carbonate Co. v. Phinney* [21], did not produce reasonable bases for any exception. The *Durando* decision concerned the treatment of S Corporation shareholders as shareholders and would not affect a determination that Dr. Sadanaga, although a shareholder, was also an employee of VSC[22]. *Texas Carbonate* improperly read the provisions of Section 530 but properly determined in any event that a shareholder-director-manager of a company was an employee for federal employment tax purposes.[23]

Elliotts, Inc. v. Commissioner[24] also treated the topic of reasonableness. The Court of Appeals for the Ninth Circuit, however, did not agree with the Commissioner and Tax Court concerning the reasonableness of the bonus paid to its CEO and sole shareholder.

Elliotts, Inc., the taxpayer, was a closely held Idaho corporation which sold John Deere Company equipment and services equipment from Deere and other manufacturers. Edward G. Elliott was the corporation's chief executive officer and sole shareholder during the tax period in question; he always had total responsibility for the business as its manager of some 40 employees. The corporation paid Elliott a fixed salary of $2000 a month plus a bonus fixed at 50% of its net

profits. For the tax years 1975 and 1976, the corporation paid Elliott a total compensation of $181,074 for 1975 and $191,663 for 1976. The Tax Court agreed that the compensations paid were unreasonable, but adjusted the Commissioner's finding to seek deficiency assessments of compensation paid in excess of $120,000 for 1975 and $125,000 for 1976.

The Court of Appeals agreed that Elliott obviously was an employee of the corporation. He performed the duties of an employee as its manager and was reasonably entitled to compensation for his services. The appeals court, however, remanded the case to the Tax Court on the issue of reasonableness of compensation. The court closely examined the shareholder-employee problem; it recognized that this situation is troublesome because the corporation and the shareholder-employee do not deal with each other at arm's length. The Commissioner and the Tax Court, however, must determine the proper allocation between compensation paid for services rendered and a share of profits distribution not deductible by the corporation. The Court observed that IRC Section 162(a) (1) permits a corporation to deduct "a reasonable allowance for salaries paid for personal services". [25] The payments must satisfy the statute's two-prong test that the compensation be in fact reasonable and be made purely for services rendered.[26]

The Court of Appeals then suggested five criteria to determine the reasonableness of compensation paid to Elliott. The court noted that a. Elliot's role as employee in the company included 80 hours of work per week as its sole and dedicated manager; b. compared to other companies' managers, Elliott did the work of three people compared to managers at other John Deere dealers; c. the character and condition of the company's sales, net income and capital value revealed the complexity of the business which Elliott managed; d. the conflict of interest which exists in the shareholder-employee relationship does not prevent Elliott from

distributing a bonus to himself despite the close scrutiny which must be given to the relationship, provided that an independent shareholder would permit a large bonus to Elliott and not view the bonus as an impairment of the shareholder's equity in the corporation; e. internal consistency in the distribution of the bonus to Elliott existed because, since its incorporation, the business had a longstanding, consistently applied compensation plan in which it paid to Elliott an annual incentive bonus equal to fifty percent of its net profits.

DECISION OF THE *WATSON* COURT

Taking all factors and evidence into account, the Court of Appeals agreed with the District Court that DEWPC was subject to a FICA tax deficiency assessment because the wholly owned S corporation had understated David Watson's wages by $67,044.00. The Court reasoned that the following assisted in the computation of a reasonable compensation for Watson: his superior qualifications as certified public accountant, including his advanced taxation degree and 20 years' professional experience; his 35 to 45 hour work week for LWBJ, which grossed between $2 million and $3 million for the tax years 2002 and 2003; the $200,000 distributed by LWBJ to DEWPC in both 2002 and 2003 compared to the exceedingly low $24,000 annual salary paid to Watson by DEWPC. The Court then agreed that, by comparing Watson's qualifications with similar professionals in the market, the District Court properly set Watson's wages at $91,044.[27]

CONCLUSION

The Internal Revenue Code, IRS publications and the decisions described above correctly indicate that the wages of a professional such as David Watson should be subject to FICA

and FUTA tax liabilities. Profit or dividend distribution to such professionals should not be used as a subterfuge to avoid the payment of such taxes, just as the payments of excessive salaries or bonuses may not be used to disguise liabilities for taxes owed by the corporations themselves.

It should be noted that the employment tax rules for S corporations may be subject to change in that S corporation shareholders who significantly participate in the business of the corporation may have to treat 70% of their combined compensation distributive share as net earnings from self-employment, and the remaining 30% as earnings on invested capital. [28] The Watson and allied decisions are certainly a more accurate way of determining tax rules, even though more complicated, rather than simplified.

ENDNOTES

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[1] See 26 U.S.C.S. 3101-3126.
[2] See 26 U.S.C.S. 3301 – 3311.
[3] 668 F.3d 1008 (2012).
[4] Although the *Watson* decision deals with the payment of wages as dividends, other cases in the court's analysis deal with the payment of dividends as wages in order to avoid even greater tax liability; see, for example, *Standard Asbestos v. Commissioner* 276 F.2d 289 (Eighth Circuit, 1960).
[5] See 26 CFR 31.3121(a)-1.
[6] See 25 CFR. 31.3121 2(a)2(d). In *H B & R Inc. v. United States*, 229 F.3d 688 even an employee's airfare may be subject to FICA tax withholding unless the airfare was to the job site and ordinary and necessary to the corporations business.
[7] *Joly v. Commissioner*, 76 T.C.M (CCH) 633, states that several interdependent factors must be considered to determine the employer-employee relationship: 1. the degree of control exercised by the principal over work details; 2. the relative investments of the party; 3. the hired party's role in hiring and paying others for the permanency of the

relationship; 5. the hired party's discretion concerning work hours and places; 6. whether the work performed constitutes and integral part of the business; 7. the relationship the parties believe they have created; 8. the provision of employee benefits.

[8] 895 F.2d. 1196 (1990).

[9] In its reasoning the Seventh Circuit Court agreed with the reasoning contained in *Royster Co. v. United States*, 479 F.2d 387 (4th Circuit, 1973).

[10] 500 F.2d 148 (8th Circuit, 1974).

[11] See IRC Section 162 (a) (1).

[12] 500 F.2d 154 (8th Circuit, 1974).

[13] 276 F.2d 289 (8th Circuit, 1960); certiorari denied, 340 U.S. 904 (1960).

[14] 197 F.2d 263, at 264.

[15] See *Union Packing Co v. Commissioner, 1955 P-H T.C. Memorandum Decisions, par. 55, 308.*

[16] See Revenue Ruling 74-44, 1974-1 C.B. 287. The Court of Appeals in *Watson* observed that such rulings need not have the force of precedent but may be used to guide the court's reasoning.

[17] 117 T.C. 141 (U.S. Tax Court, 2001); the decision, as noted in the footnote below was affirmed as part of the 2002 *Yeagle* decision, which included the *Veterinary Surgical Consultants* ruling in it's title.

[18] The Veterinary Surgical Case was affirmed under a different name, *Yeagle Drywall Co. v. Commissioner*, 54 Fed. Appx. 100 (Third Circuit 2002) ; See also *Spicer Accounting, Inc. v. U.S.*, 918 F. 2d 90 (Ninth Circuit, 1990) for a discussion of the immateriality of the taxpayer's intent to treat the payments as distributions rather than as wages.

[19] See section 3 of Rev. Proc. 85-18, P.l.95-600 as amended.

[20] 70 F.3d 548 (9th Circuit, 1995).

[21] 307 F.2d 289 (5th Circuit, 1962).

[22] See the *VSC* decision, 117 T.C 141 at 145.

[23] See the *Texas Carbonate* discussion in *Yeagle* 54 Fed. Appx. 100 at 103.

[24] 716 F.2d 1241 (9th Circuit, 1983).

[25] 716 F.2d 1241 at 1243.

[26] See Treasury Regulations Section1.162-7 (a)(1960).

[27] 668 F.3d 1017.

[28] See 2014 KPMG LLP publication concerning 2014 Ways and Means Chairman's Tax Reform Discussion Draft, p. 34. This proposal, however, has received no further impetus.