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## LETTER FROM THE EDITORS

Welcome to the *Journal of Legal, Ethical and Regulatory Issues*. This journal was formerly named the *Academy for Studies in Business Law Journal*. It is owned and published by the Allied Academies, Inc., a non profit association of scholars whose purpose is to encourage and support the advancement and exchange of knowledge, understanding and teaching throughout the world. The *JLERI* is a principal vehicle for achieving the objectives of the organization. The editorial mission of this journal is to publish empirical and theoretical manuscripts which advance understanding of business law, ethics and the regulatory environment of business.

We changed the name of the journal to better reflect our broader mission. Readers should note more clearly now that our mission goes beyond studies involving business law or the effect of legislation on businesses and organizations. We are also interested in articles involving ethics. We would like to publish more manuscripts dealing with the ethical environment, business ethics and the impact of ethics on organizations and businesses. In addition, we invite articles exploring the regulatory environment in which we all exist. These include manuscripts exploring accounting regulations, governmental regulations, international trade regulations, etc., and their effect on businesses and organizations. Of course, we continue to be interested in articles exploring issues in business law.

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Sarah Pitts  
Christian Brothers University

Aileen Smith  
Stephen F. Austin State University

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# **LEGAL ISSUES**

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# VIRTUAL MERGERS AND ANTITRUST LAW IN HEALTH CARE

**W. R. Koprowski, Texas A&M University-Corpus Christi**  
**Steven J. Arsenault, College of Charleston**

## ABSTRACT

*Although the health care industry has experienced tremendous consolidation during the past two decades, many hospitals have been excluded because of religious, financial or legal restrictions that have prevented their merger. More recently, however, health care organizations have employed a variety of innovative structures to permit participating entities to coordinate certain operational functions while maintaining varying degrees of independence. Because these collaborations achieve many of the benefits of a true merger, they are often referred to as "virtual mergers." Though virtual in name, these collaborations face real antitrust scrutiny. In the first virtual merger case to reach the courts, an examination of price fixing and market allocation activities of the new entity did not survive antitrust analysis. The results of this case in conjunction with increased activism among health insurers and state attorneys general may portend a new round of antitrust enforcement with significant implications for healthcare organizations.*

## INTRODUCTION

Recent changes in competitive pressures and market forces have led to consolidations in a number of different industries. Historically, these consolidations have taken the form of mergers or acquisitions; examples can be found in the accounting profession (mergers among the "former" Big Eight, now the Big Four) as well as the telecommunications industry (MCI-Worldcom & America Online-Time Warner). More recently, however, operational and legal impediments have encouraged more innovative strategies for collaboration. Called strategic alliances, these collaborations offer many of the advantages of a merger or acquisition without the concomitant disadvantages. Code sharing arrangements in the airline industry are the most prevalent example of these types of alliances (AuBuchon, 1999).

In the health care area, in addition to the benefits of economies of scope and scale, successful contracting with insurers requires both a comprehensive array of medical specialty services and an expanded geographic market. Consequently, merger and acquisition activity between 1995 and 1997 increased 27 percent, with more activity occurring in the first quarter of 1997 than in all of 1996 (Gifford, 1999). Though organizational and legal impediments have dampened traditional

merger and acquisition activity for the past three years, collaborations among health care providers continue unabated (Galloro, 2002). In an effort to achieve the benefits of consolidation in such an environment, health care entities are utilizing a variety of structures and alliances under which the participating entities coordinate certain operational functions while maintaining varying degrees of independence. Because these alliances achieve many of the benefits of a true merger, they are often referred to as "virtual mergers."

### **OVERVIEW OF VIRTUAL MERGERS IN HEALTH CARE**

A virtual merger permits individual components of the merger to maintain a degree of autonomy while benefiting from the "merger" arrangement. The motives for choosing a virtual merger over an actual merger vary. In some cases, the parties intend eventually to merge but use the virtual merger structure as a means to test the waters before diving in. Where the test arrangement works well, the parties may decide to proceed with an actual merger; however, they may still wish to retain some degree of autonomy and their separate identities after the merger. In such cases, one of various holding company models may be used, under which the parties become subsidiaries of a parent entity that serves as a holding company (Lockman & Silverman, 1998). In other cases, the parties do not ever intend to pursue an actual merger because they are either unable or unwilling to merge for religious, financial or other reasons. For example, mergers involving a Roman Catholic hospital must address numerous issues raised by Vatican policy in areas such as contraception, abortion and sterilization. Whether or not the parties intend to eventually pursue an actual merger, the virtual merger structure is the same.

The parties to the virtual merger generally enter into a contractual arrangement (often called a "joint operating agreement") under which each of the parties retains ownership of its assets and responsibility for its liabilities but agrees to relinquish some degree of control over its operations. In most cases, this results in the creation of a separate legal entity (a corporation, partnership or limited liability company) to oversee the joint operations of the hospitals. The joint operating agreement will specify the manner in which the new entity will be governed. One of the parties will sometimes have primary control of the new entity, but in most cases the parties share responsibility for appointing the new entity's governing body, which, in addition to members of the respective organizations, may include members of the community. The new entity oversees the parties' joint operations, although the parties sometimes agree to retain separate control over some operational aspects.

A good example of a common virtual merger structure is the 1995 affiliation between the Medical Society Health System (the parent corporation of Roper Hospital and Baker Hospital) and Bon Secours-St. Francis Xavier Hospital, all located in Charleston, South Carolina. The affiliation resulted in the formation of Lowcountry Health System, whose objectives were the development of a network of primary-care physicians to pursue managed care contracts through a for-profit

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management service organization and the coordination of the hospitals' non-hospital-based outpatient services (Burda, 1995). However, the hospitals' acute-care and outpatient services provided within the hospitals were to remain independent and, in fact, competing programs. At the time of the affiliation, the parties anticipated eventually pursuing an actual merger, but given the hospitals' ownership differences (with Bon Secours-St. Francis being a Roman Catholic facility), the virtual merger structure enabled them to begin achieving some of their integration goals immediately (Burda, 1995).

### **APPLICATION OF ANTITRUST LAW TO TRADITIONAL HOSPITAL MERGERS**

Like merger and acquisition transactions in other industries, mergers involving hospital systems are subject to antitrust scrutiny under federal law<sup>1</sup> by the Federal Trade Commission (FTC), the U.S. Department of Justice (DOJ) and under state law by relevant state antitrust enforcement agencies<sup>2</sup>.

The primary antitrust concern in hospital merger transactions is Section 7 of the Clayton Act (1914), which prohibits mergers and asset acquisitions that may substantially lessen competition or tend to create a monopoly. Unlike the Sherman Act (1890), which only reaches completed activities that restrain trade or result in a monopoly, the Clayton Act was specifically drafted to prevent those transactions that are likely to have anticompetitive effects (Stephens, 1995). This goal is accomplished through a pre-merger notification (commonly known as a Hart-Scott-Rodino filing) applicable generally to mergers where the value of the acquired entity is \$10 million or greater.

In a typical scenario, two hospitals that have agreed to merge would notify the FTC and the DOJ of their intent. The Clayton Act prohibits the consummation of the merger transaction until this notification is filed and a 30-day waiting period has expired. During this waiting period, the FTC and/or DOJ review the information provided by the parties to determine whether the proposed transaction may, if consummated, violate the antitrust laws. The government may extend the 30-day waiting period for up to an additional 20 days or may terminate the waiting period early and allow the transaction to proceed. If the government believes that the proposed transaction will violate the antitrust laws if consummated, it may institute a proceeding in U.S. District Court for a preliminary injunction against consummation of the transaction. The Act also provides for civil penalties of up to \$10,000 per day for each day during which a violation of the filing requirements exists and for injunctive relief.

In 1992, the DOJ and the FTC issued the Horizontal Merger Guidelines (U.S. Department of Justice and Federal Trade Commission [DOJ/FTC HMG], 1992) that set forth federal antitrust policy applicable to mergers in all industries. These guidelines do not specifically address hospital mergers. Under the Horizontal Merger Guidelines, the analytical process for determining whether an antitrust challenge to a horizontal merger is appropriate focuses on whether the merger is likely to create or enhance market power or to facilitate its exercise; this analysis consists of five inquiries.

First, will the merger significantly increase concentration and result in a concentrated market? Second, will the merger raise concerns about potential adverse competitive effects? Third, would entry by federal antitrust enforcement authorities be timely, likely and sufficient either to deter or to counteract the competitive effects of concern? Fourth, are there any efficiency gains that reasonably cannot be achieved by the parties through other means? Fifth, absent the merger, would either party to the transaction be likely to fail, causing its assets to exit the market?

In 1996, the DOJ and the FTC issued the Statements of Antitrust Enforcement Policy in Health Care (U.S. Department of Justice and Federal Trade Commission [DOJ/FTC SAEP], 1996) setting forth the agencies' position on numerous antitrust concerns affecting health care organizations. Statement 1 specifically addresses mergers among hospitals and carves out an exception for mergers involving general acute-care hospitals where one of the hospitals has an average of fewer than 100 licensed beds over the three most recent years, has an average daily inpatient census of fewer than 40 patients over the three most recent years, and is not less than 5 years old. In these cases, absent undefined extraordinary circumstances the DOJ and FTC will not challenge the merger on antitrust grounds.

Where this rather limited exception does not apply, hospital mergers are analyzed under the five-step process set forth in the Horizontal Merger Guidelines. This analysis traditionally focused on the determination of relevant geographic and product markets (Vistnes, 1995), as measured by the Elzinga-Hogarty test, which establishes the dimensions of the relevant geographic market for inpatient services and the Herfindahl-Hirschman Index (HHI), which measures the pre-merger and post-merger market shares in the relevant markets (Gifford, 1999). However, Bazzoli, Marx, Arnould and Manheim (1995) suggest that because of selective application of the guidelines to hospital mergers that exceeded the stated limits for anticompetitive effects, the guidelines may not provide meaningful direction to hospitals considering entering into a merger transaction. A more recent study by Gifford (1999) built upon the 1995 results and suggests that, based upon analysis of trends in recent antitrust enforcement cases, in order to avoid antitrust issues, merging hospitals will need to be able to demonstrate that the merger results in substantial and quantifiable savings for consumers. Thus, the focus of federal antitrust scrutiny of hospital mergers appears to have shifted from a quantitative analysis of market concentrations to a more qualitative analysis based upon merger efficiencies.

### **APPLICATION OF ANTITRUST LAW TO VIRTUAL MERGERS**

In a traditional hospital merger, the transaction involves one hospital's acquisition of the equity or assets of a competitor. In contrast, a virtual merger involves only contractual arrangements under which the parties form an alliance, and not an equity or asset transfer; it is in this sense that the merger is "virtual." Thus, the issue that arises is how the creation of the virtual merger should be analyzed for antitrust purposes. (Once the virtual merger transaction is completed, the activities

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of the merged entity are tested for antitrust violations under §§ 1 and 2 of the Sherman Antitrust Act.)

While each of the parties to the transaction does retain its own individual identity, Section 7 of the Clayton Act applies whether the equity or asset acquisition is direct or indirect. It is easy to identify those transactions in which a direct equity or asset transfer occurs. In virtual mergers, however, there is no direct acquisition. Thus, the Clayton Act will apply only if there is an indirect equity or asset transfer. While it is not entirely clear what will constitute an "indirect" acquisition, it is clear that the formation of a new corporation by two competitors to carry out a joint venture will be subject to scrutiny under Section 7 of the Clayton Act. *United States v. Penn-Olin Chemical Co.*, 378 U.S. 158 (1964). Botti (1998) argues that a virtual merger, in which the parties create a separate legal entity to oversee the joint operations of the hospitals, is the same type of transaction and should be analyzed for antitrust purposes as a joint venture.

Susman and Martland (1994) have suggested that joint venture antitrust analysis is simpler than merger antitrust analysis because the formation of such ventures is governed by the rule of reason. Under the rule of reason test, the procompetitive benefits of challenged conduct is weighed against any reduction in competition that the joint venture is likely to produce. *Chicago Board of Trade v. U.S.*, 246 U.S. 231 (1918). Thus, where joint ventures provide a beneficial product or service to the marketplace, they are unlikely to raise significant antitrust issues<sup>3</sup>.

While this analysis uses different language, in fact, it is quite similar to the present qualitative analysis for traditional mergers, which focuses on the merger efficiencies resulting from the parties' combination. In both cases, the focus of the analysis is making sure that the transaction is in the best interest of consumers.

The antitrust analysis applicable to joint venture formation (and, by analogy, virtual merger formation) is similar to the analysis for a traditional hospital merger in procedural aspects as well. The notification requirements under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 apply to the formation of joint ventures, requiring that an entity acquiring voting securities in the venture make the filing under the Act. The joint venture entity itself, however, does not have to file. Further, no filing at all is required if the resulting joint venture entity qualifies as a tax-exempt organization under the Internal Revenue Code. This will be especially important in the case of hospital mergers, since most hospitals are tax-exempt organizations and will structure the joint venture entity to be exempt as well. Where the joint venture entity is not tax-exempt, the Hart-Scott-Rodino filing procedures are similar to those applicable to a traditional merger.

## **VIRTUAL MERGERS AND THE COURT**

Only one virtual merger case has been challenged in court on antitrust grounds. In *New York v. Saint Francis Hospital* (2000), the U.S. District Court for the Southern District of New York examined claimed violations of the Sherman Act and a state antitrust statute. Hailed as innovators

with the formation of a joint venture, Mid-Hudson Health, Vassar Brothers Hospital and Saint Francis Hospital jointly owned and operated Mid-Hudson from the time of its formation and delegated to Mid-Hudson direct control of three clinical operations specified in Certificate of Need applications filed in 1988. A 1995 agreement between Vassar Brothers, Saint Francis and Mid-Hudson unified substantially all hospital operations, including the creation of a single parent board, merging medical staffs, combining development and control over clinical services and integrating administrative services. In planning the virtual merger, the DOJ and the New York State antitrust authorities were notified and there were no objections.

In 1999, prompted by complaints by two of largest managed care organizations in the area that Mid-Hudson was jointly negotiating contracts, the New York State Attorney General brought suit under Section 1 of the Sherman Act and a New York State antitrust statute, claiming that Saint Francis and Vassar Brothers, through their agent, Mid-Hudson, fixed the rates, terms and conditions for services provided at the hospitals and wrongfully divided the market for the provision of services between them.

In the Saint Francis case, the state did not challenge the formation of Mid-Hudson under a Clayton Act analysis. Instead, the court looked at the post-formation activities of the entity, applying a Section 1 Sherman Act Per Se analysis and concluding that "the activities at issue here, joint negotiations with third parties, defendants' allocation of services among themselves and their agreement not to compete for patients, are among those activities the courts have found unlawful in and of themselves" (New York v. Saint Francis Hospital, 2000, p. 418). While the court considered a number of the defendants' arguments in favor of a Rule of Reason analysis (including the fact that Mid-Hudson was a joint venture, the State was involved in the formation of Mid-Hudson, the challenged actions were ancillary to a legitimate business activity, the courts had no prior experience with a virtual merger entity such as Mid-Hudson, the community supported Mid-Hudson and its activities, and the complaining managed care organizations were guilty of inequitable conduct), the court rejected such arguments, concluding that a Per Se analysis was appropriate. Even the fact that the Department of Justice and the New York State antitrust regulators reviewed the plans for the virtual merger and did not object did not persuade the court to apply a Rule of Reason analysis where price fixing and market allocation activities were involved.

## **CONCLUSION**

As the health care operating environment continues to increase in complexity, hospitals will feel the need to consolidate activities in order to compete successfully in the health care market. While hospitals will sometimes engage in traditional mergers and acquisitions, operational and/or legal impediments will continue to encourage the use of the virtual merger as a consolidation strategy that will enable these hospitals to successfully compete.

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Both traditional and virtual mergers raise potential antitrust issues. While the antitrust analysis of the traditional merger focuses on merger efficiencies, it was generally thought that the analysis of the virtual merger employs a rule-of-reason analysis and focuses on whether the transaction will lead to the production of beneficial products and/or services. While the actual tests employed in traditional and virtual mergers are different, the resulting analyses in both focus on consumer benefit. Given this similarity in results, it is unclear that any difference in the tests for traditional and virtual mergers is warranted. More disconcerting is the lack of certainty involving antitrust issues and the risk that years later the operations of the "merger" may be challenged under a Sherman Act analysis. As the Saint Francis court recognized, application of the federal antitrust laws to virtual mergers in healthcare could ultimately lead to the demise of one or more of the participating hospitals, which ironically would result in the end of local competition and an increase in prices to consumers.

In January 2002, the U.S. Justice Department's Antitrust Division announced plans to disband its 17-attorney healthcare taskforce and to cede healthcare merger oversight to the Federal Trade Commission despite the fact that the FTC readily admitted inability to successfully challenge mergers in court (Taylor, 2002a). However, indications are that antitrust divisions of state attorneys general will play a more aggressive role in antitrust, as evidenced by increased enforcement activity in California, Connecticut, Florida, Maryland, Massachusetts, Michigan, Missouri, New Hampshire, New York, Pennsylvania Texas Washington and Wisconsin (Taylor, 2002b). Moreover, antitrust suits by healthcare insurers are on the rise, with at least six private cases recently filed (Taylor, 2001). It appears that activism among health insurers and state attorneys general may be leading to a new round of antitrust enforcement action under the Sherman Act, which carries significant potential civil and criminal sanctions, against the operations of virtually merged entities whose formation initially survived antitrust scrutiny under the Clayton Act.

#### ENDNOTES

<sup>1</sup> The primary bases for antitrust actions concerning horizontal acquisitions and mergers under federal law are Section 7 of the Clayton Act, 15 U.S.C. § 18, which prohibits mergers if their effect "may be substantially to lessen competition, or to tend to create a monopoly"; Section 1 of the Sherman Act, 15 U.S.C. § 1, which prohibits mergers if they constitute a "contract, combination . . . , or conspiracy in restraint of trade"; and Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45, which prohibits mergers if they constitute an "unfair method of competition."

<sup>2</sup> This article focuses primarily on federal antitrust enforcement as it relates to traditional and virtual hospital mergers. State regulatory legislation may provide an exemption from federal antitrust laws where the state law "articulates and affirmatively expresses an intent to displace competition with regulation and actively supervises the merging organizations' compliance." *FTC v. Ticor Title Insurance Co.*, 112 S.Ct. 2169 (1992).

<sup>3</sup> DOJ/FTC SAEP (1996) provide guidance regarding the application of the antitrust laws to hospital joint ventures in very limited circumstances. Specifically, Statement 2 addresses hospital joint ventures involving

high technology or other expensive health care equipment, Statement 3 addresses joint ventures involving specialized clinical services. Statements 4-9 are not hospital specific but address joint venture activities, which may in some circumstances involve hospitals.

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# WHAT HAPPENS WHEN "I WILL" BECOMES "I WON'T": AN EXAMINATION OF THE LEGAL LANDSCAPE OF COURTSHIP GIFT DISPUTES

**Edward J. Schoen, Rowan University**

**Joseph S. Falchek, King's College**

**Barry H. Williams, King's College**

*"The courtship and engagement periods are usually happy times for a couple as they build a relationship and look toward marriage. However, happiness may fade, circumstances may change, the relationship may end, and the planned engagement may be canceled, repudiated, or frustrated, with no marriage occurring between the parties. When such a situation arises, one party to the courtship or engagement may seek to recover gifts of money or property previously given to the other party, requiring a legal determination of the parties' respective rights in the money or property." <sup>1</sup>*

## ABSTRACT

*Business law/legal environment professors frequently and successfully use engagement ring disputes in the classroom to illustrate several important legal concepts, including rights in personal property, conditional gifts and transfers, contracts involving a promise to marry, availability of various legal and equitable remedies, and federal tax implications of property transfers. Equally important, students relate well to the subject matter, perhaps because it is closer to their life experience, and appreciate being appraised of the new, no-fault developments in the field. Hence, the authors of this article re-examined the topic of engagement gifts, and discovered a marvelous niche of interwoven and evolving legal concepts that can successfully be used throughout a business law/legal environment course to provide students a rich learning experience.*

*The article begins with a hypothetical situation involving a controversy between a formerly engaged couple fighting over ownership of a valuable engagement ring, as well as other presents given during their courtship. The hypothetical is a composite of several leading cases resolving engagement gift disputes, and should generate lively student discussion. Thereafter, questions are posed that (1) explore the principal legal theories employed by courts in resolving engagement gift quarrels, (2) examine how the outcome may change as the circumstances of the parties vary (for example, if one the engaged parties dies before the marriage can take place, is a minor, or is married to someone else at the time of their engagement), (3) assess the impact of so-called "Heartbalm Laws" on engagement gift lawsuits, (4) investigate the possibility of third-party rights to engagement gifts, (5) probe the impact of the parties' marital status, capacity, and wrongful*

*conduct in recovering courtship gifts, and (6) examine the federal tax consequences of engagement gifts.*

### **CASE INCIDENT**

In August of 1999, Larry, an unmarried and very successful 55-year old stockbroker, proposed marriage to Janet, a recently divorced, 50 year old owner of a successful insurance business. Larry presented Janet with a diamond engagement ring costing him \$10,000, the appraised value of which was \$18,000. Janet accepted both Larry's marriage proposal and the ring.

Over the next two months, Larry gave several presents to Janet, including \$15,000 cash for her trousseau and, on Janet's birthday, an emerald dinner ring costing him \$10,000 with an appraised value of \$7,500. Janet conveyed a parcel of real estate she owned to Larry, so that she and Larry could proceed with their plans to construct their home on the property. Pleased with Larry's engagement to Janet, his parents gave Janet several family heirlooms, including sterling silver service for twelve and a gold bracelet and matching pendant.

Unfortunately, discord developed in the relationship between Larry and Janet, and in November of 1999, claiming she was unsure their marriage would be happy, Janet asked Larry to end the engagement. Acquiescing in her request, Larry asked for the return of the engagement ring. Janet obliged, and returned the engagement ring to Larry.

Larry and Janet then reconciled. In early January 2000, Larry again proposed and offered her the engagement ring, and Janet agreed to marry him and accepted the ring. In March of 2000, however, Larry called off the engagement, and asked Janet to return the engagement and dinner rings. Janet refused, and litigation ensued in which (1) Larry seeks return of the engagement and dinner rings or judgment for their value, and judgment in the amount of \$15,000 for his contribution for her trousseau, and (2) his parents seek the return of the family heirlooms.

Janet claims that Larry was unfaithful to her during their engagement and that Larry feigned his promise to marry her in order to deceive her into conveying her real estate to Larry. Janet seeks to retain ownership of the engagement and dinner rings and the family heirlooms, and to have Larry reconvey the real property to her.

### **DISCUSSION QUESTIONS**

#### **1. What must Larry establish to succeed in his lawsuit against Janet?**

Under the prevailing view, the donor is entitled to the return of engagement gifts if they are given on the condition that marriage ensue and it does not.<sup>2</sup> Courts are willing to imply a condition of marriage in the instance of gifts that, by their very nature, can be said to have been given in contemplation, and on the condition, of marriage, the clearest example

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of which is the engagement ring.<sup>3</sup> In the cases of other gifts made in contemplation of marriage, the courts will demand proof that the gift was made expressly or impliedly conditional upon fulfillment of the donee's promise to marry the donor.<sup>4</sup>

Hence, ignoring for the moment Janet's charges of Larry's infidelity and wrongful breach of engagement, Larry should be entitled to the return of the engagement ring he gave Janet, because the court can safely infer Larry made the gift on the condition of his marriage to Janet. Likewise, if Larry can establish his gift of \$15,000 cash was provided for Janet's trousseau (i.e. to acquire clothes, accessories and household items needed by a bride), the court can also imply from the nature of the gift that it was made on the condition of marriage, and, no marriage having taken place, the gift should be returned to Larry. Larry is not likely entitled to the return of the dinner ring, however, because there is no indication he gave Janet the dinner ring on the condition their marriage take place, and, coinciding with Janet's birthday, the nature of the gift does not support the inference it was based on the condition their marriage ensue.<sup>5</sup>

**2. Does Larry's alleged infidelity during his engagement to Janet or his conduct in breaking their engagement affect his right of recovery?**

As a general rule, the donor may recover engagement gifts if the engagement is called off by mutual agreement.<sup>6</sup> Where the donor unjustifiably breaks the engagement, however, the donee may be given the right to possess the betrothal gifts or to recover their value.<sup>7</sup> Likewise, where the donee unjustifiably breaks the engagement, a donor who makes a gift upon condition of marriage may recover the betrothal gifts.<sup>8</sup>

Under this view, Janet acted correctly in returning the engagement ring to Larry in November 1999, because Larry and Janet mutually agreed to end their engagement to marry. In March 2000, however, the situation had changed. Larry unilaterally attempted to terminate his engagement to Janet, but she refused. If Larry has no grounds to terminate the engagement, Janet should be entitled to retain the engagement and dinner rings, as well as the trousseau contribution, in those jurisdictions that examine the fault of the party contributing to the engagement termination. This result would be particularly true if Janet can establish she terminated her engagement to Larry because of his infidelity, in which case Janet would be allowed to retain all of the gifts Larry has given her.

**(3) Can Larry succeed in his cause of action by arguing the "fault" of the parties in terminating their engagement should not be considered by the court in resolving engagement present disputes?**

In a growing number of jurisdictions, courts have recognized that, upon termination of an engagement, gifts in contemplation of marriage are to be returned to the donor without analysis of the parties' fault in, or justification for, terminating the engagement.<sup>9</sup> Three main reasons are advanced for this policy shift: (1) courts are reluctant to attribute fault to a party who merely changes his or her mind as to the desirability of the other person as a marriage partner,<sup>10</sup> (2) a primary purpose of the engagement period is to allow a couple time to test the permanency of their feelings, and the donor should not be penalized for preventing what may be an unhappy marriage,<sup>11</sup> and (3) the modern trend in legislation and the courts is toward a policy that removes fault-finding from the dynamics of divorce, and the policy statements governing broken marriages are equally relevant to broken engagements.<sup>12</sup>

Hence, under the no-fault approach to betrothal gifts, Larry should be entitled to recover the engagement ring and his contribution to Janet's trousseau, both gifts being given on the condition that the parties marry and Larry's "fault" in terminating the engagement being irrelevant to the outcome. As noted above, however, he would not be entitled to the return of the dinner ring, that gift not having been made on the condition of marriage and not being one from whose nature the condition of marriage can be inferred.

**(4) Can Janet succeed in her action against Larry to have the real property reconveyed to her?**

Janet should succeed in her action to compel Larry to reconvey the real property to her. Her land was conveyed to Larry for the purpose of facilitating the construction of their marital home, and thus can be said to have occurred on the condition that they marry. That condition not having been fulfilled, Larry should be ordered to reconvey the land to Janet.<sup>13</sup> Notably, Larry and Janet's first engagement was terminated by mutual agreement, and the second engagement was ended without any indication of fault on the part of Janet. Hence, even if Larry and Janet reside in a jurisdiction that inquires into the fault of the parties in ending their engagement in determining the parties' rights to engagement gifts, Janet should succeed in her claim for the reconveyance of the real property.

**(5) Are Larry's parents entitled to the return of the family heirlooms, including the sterling silver service for twelve and the gold bracelet and pendant?**

Third party donors of gifts to one or both members of an engaged couple can recover the engagement gift when the expected marriage fails to occur.<sup>14</sup> Larry's parents gave the heirlooms to Janet upon her engagement to Larry, and, given their family importance, those gifts can safely be said to be conditional upon Larry and Janet's marriage. Larry and Janet not having married, Larry's parents are entitled to the return of the heirlooms.<sup>15</sup>

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- (6) Assume that Janet's divorce was not finalized until February 2001. What impact does her marital status have on her right to retain the engagement and dinner rings and trousseau contribution and to recover the real property conveyed to Larry?**

If Janet's divorce did not become final until February 2001, she was married to another individual when she accepted both of Larry's marriage proposals. As a general rule, when either the donor or the donee of an engagement gift is already married to another at the time of the gift, and his/her marital status is known by the other party, the donor is not entitled to recover the gift, because (1) an impediment to the proposed marriage exists, and the engagement is necessarily conditioned upon the procurement of a divorce, contrary to public policy,<sup>16</sup> and (2) an agreement to marry a married individual is illegal and void, and the court will refuse to further an illegal transaction contrary to public policy in favor of marriage.<sup>17</sup> If, however, the donor is unaware that the donee is married at the time they become engaged, the donor may qualify as the innocent party and recover the engagement gift.<sup>18</sup>

Consequently, if Larry knew Janet was married to another when they became engaged, Larry is not entitled to recover his engagement gifts to Janet, because the court will not facilitate a transaction which encourages divorce, and Larry does not possess "clean hands." On the other hand, if Larry did not know Janet was married to another when he became engaged to Janet, he may qualify as an innocent party to an illegal agreement, and may be entitled to the return of his gifts to Janet made on condition of marriage, provided his misconduct, if any, during his engagement to Janet does not make him in pari delicto thereby precluding the court from giving him a remedy.

Janet was certainly aware her divorce was not final when she agreed to marry Larry. Therefore she is not entitled to the reconveyance of the real property from Larry, because her agreement to marry Larry is contrary to public policy and the court will not further such an illegal transaction.

- (7) Assume that Janet was a minor both at the time of her engagement to Larry and when she received the engagement gifts. What impact does Janet's infancy have on her right to retain the engagement and dinner rings and trousseau contribution?**

While Janet's minority may be a defense to an action for breach of a contract to marry, her infancy does not prevent Larry and his parents from recovering their engagement gifts. In the former instance, Janet's infancy shields her from liability for damages for breach of contract; in the latter instance, infancy does not constitute a shield to prevent the return of property belonging to another.<sup>19</sup>

Notably, however, if the minor donee has disposed of the engagement gift, the donor is not entitled to recover from the minor donee when the marriage does not take place, because the sole remedy then available - recovery of the value of the gifts - is akin to damages for breach of contract to marry.<sup>20</sup>

Hence, if Janet were a minor at the time of her engagement to Larry and when she received the engagement gifts, she must return them to Larry and his parents, provided she still possesses the gifts.

- (8) Assume that, shortly after becoming re-engaged to Janet in January 2001, Larry suffers a heart attack and dies. What impact does Larry's untimely death have on his claim to recover the engagement and dinner rings and trousseau contributions?**

At first blush, it appears logical that, when marriage is prevented by the death of either the donor or the donee of a betrothal present, the donor (or the estate of the donor) of the engagement gift should be entitled to recover the engagement gift from the donee (or the donee's estate).<sup>21</sup> There is, however, little or no authority among courts that have considered the issue to support such a proposition. On the contrary, courts appear to be reluctant to strip the engagement gift from the surviving donee or his/her estate in the event of the death of either the donor or the donee.<sup>22</sup> Hence, even though Larry's death prevents the marriage from occurring, the gifts of the engagement ring, the trousseau contribution, and the dinner ring will likely not be recovered by Larry's estate.

- (9) Assume that Janet's can establish her claim that Larry feigned his promise to marry her in order to trick her into conveying her real estate to Larry. How does Larry's deceit affect Janet's claim for the return of the real estate?**

If the recipient of a gratuitous transfer of either real or personal property from a betrothed actually intended not to marry the transferor or was otherwise deceptive in obtaining the property, recovery of the property by the transferor will be required on the grounds of fraud.<sup>23</sup> Hence, Larry's deceit provides Janet with an independent cause of action against Larry for the return of the real estate.

- (10) Assume that Janet is an innocent and unsophisticated young woman who recently accepted employment as a data entry clerk in Larry's stock broker business and that Larry persuaded her to deed her real property to him in return for his promise to marry her.**

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As the employer of an innocent and unsophisticated employee, Larry occupies a position of power in so far as Janet is concerned, and is in a position to exert significant influence on her. If Janet is able to establish that her transfer of real estate to Larry occurred because of Larry's power and persuasion, the transfer may be said to be the result of undue influence, thereby providing Janet with an additional cause of action to recover the real estate from Larry.<sup>24</sup>

**(11) What impact do the so-called "Heart-Balm" statutes have on the parties' claims to the return of engagement gifts?**

A number of states have abolished by statute the right of action for breach of promise to marry. These statutes, passed in approximately fifteen jurisdictions,<sup>25</sup> are commonly referred to as "heart balm" acts. As a general rule, heart-balm acts neither abolish the right to recover engagement gifts given on condition of marriage, nor affect the rights and duties of the parties to gifts passing between them, but simply bar actions for damages suffered from loss of marriage, humiliation, and other direct consequences of breach of promise to marry.<sup>26</sup> Hence none of the parties' claims for the return of the engagement gifts should be affected by the passage of a heart-balm statute.

**(12). What are the federal tax implications, if any, of Larry and Janet's exchange of engagement gifts?**

All income from whatever source derived is included in a taxpayer's gross income for income tax reporting purposes, unless it is otherwise excluded by statute.<sup>27</sup> Under the facts of this case, the issue is whether the receipt by Janet would be subject to an exclusion from gross income on the basis that it was a gift.<sup>28</sup> To be considered a gift, the transfer of property must proceed from a generosity that is detached and disinterested from any expectation of receiving something in return.<sup>29</sup> Courts have held that a transfer of property in exchange for another's marital rights creates a taxable sale of those marital rights and the property.<sup>30</sup> The transfer of property must proceed as an absolute gift when the gift is consummated, in this case upon marriage. Once the marriage occurs, the consummation of the gift would be exempt from tax as a marital transfer.<sup>31</sup>

The legal fees incurred in the recovery of the rings and other property by Larry may be considered to be tax deductible. To become a deduction, the expense needs to be incurred for the production of income or the conservation of property held for the production of income.<sup>32</sup> Any legal expenses incurred to recover the rings and other property cannot be deducted in this case, because they did not proceed from an income-producing activity, e.g., a jewelry business.<sup>33</sup>

When a transfer of property is considered to be a gift, then the amount of any gift tax must be calculated. A taxable gift exists when the fair market value of the transfer exceeds the annual exclusion of \$10,000.<sup>34</sup> Any transfers between spouses is excluded from the calculation of taxable gift as a marital transfer.<sup>35</sup> In this case, the issue of when the gift is completed would determine the classification for gift tax purposes.

- (13). Assume Janet sells her engagement ring for \$20,000 and her dinner ring for \$7,000, both transactions occurring in 2003. Are those sales subject to federal income tax? How should Janet calculate the gain or loss on the sales? What income, if any, must she report on her federal income tax return?**

The determination of any gain or loss upon disposition of the rings by Janet will be calculated by deducting the adjusted basis from the amount realized upon the disposition.<sup>36</sup> The tax rate to be applied to the gain will be determined by the classification of the rings as capital or ordinary income assets and their holding period.<sup>37</sup> The amount realized is the amount of money received by the seller plus the fair market value of any property received plus any debt relief.<sup>38</sup> In this case, Janet would have an amount realized of \$27,000, equal to the amount of cash received from the sales.

Adjusted basis is determined by taking into account the means of acquisition of the asset. There are two possibilities presented in this case: gift and sale of marital rights. In the case of a gift, the basis of the property is what it was in the hands of the donor or the last preceding owner who acquired the property by other than gift.<sup>39</sup> Based upon the information provided in the case, the adjusted basis of the diamond ring and dinner ring would be 10,000 each. If the determination is made that there had been an exchange of marital rights for the rings, the adjusted basis will be determined using the rules for a purchase. The general rule for a purchase is that the adjusted basis shall be its cost determined by the fair market value of the asset given up.<sup>40</sup> Based upon the facts of the case, the adjusted basis for the diamond engagement ring would be \$18,000 and for the emerald dinner ring, \$7,500.

Given this analysis, the gain or loss would be calculated as follows:

- (1) Gift - \$10,000 gain upon sale of the diamond engagement ring (\$20,000 amount realized less \$10,000 adjusted basis) and a \$3,000 loss upon the sale of the dinner ring (\$7,000 amount realized less \$10,000 adjusted basis).
- (2) Exchange - \$2,000 gain upon the sale of the engagement ring (\$20,000 amount realized less \$18,000 adjusted basis) and a \$500 loss upon the sale of the dinner ring (\$7,000 amount realized less \$7,500 adjusted basis).

The tax rate imposed upon the gain will be either the marginal ordinary income tax rate of the taxpayer or the capital gain tax rate based upon the classification of the gain and

the holding period.<sup>41</sup> In order to be a capital gain, the sale must proceed from the disposition of a capital asset. A capital asset is defined as property held by the taxpayer with certain enumerated exclusions.<sup>42</sup> The rings held by Janet would be capital assets, since they do not fit any of the exceptions to the capital asset definition. The holding period will be determined by the length of time from the date of acquisition through the date of disposition. The exception to this rule applies to assets acquired by gift. In such circumstances the holding period includes the holding period of the donor. In this case, under either the gift or exchange scenario, the holding period would be long-term, since the rings were both held for more than one year.<sup>43</sup> As a long-term gain, preferential tax rates of either 20% or 10% would apply to the gain with the choice determined by the marginal tax bracket of the taxpayer.<sup>44</sup>

## CONCLUSION

By closely examining and discussing the multiple legal issues permeating the situation in which Janet, Larry and his parents find themselves, students in legal environment/business law courses can better appreciate the legal implications making and recovering engagement gifts. In the process, a stimulating learning exercise is provided which permits the professor to guide students through a fascinating niche of interwoven legal concepts, to explore the principal legal theories employed by courts in resolving engagement gift quarrels, to examine how the outcome of such disputes may vary as the circumstances of the parties change (e.g. death, marital status, and incapacity), to understand the distinction between actions for breach of agreement to marry and actions for return of property transferred to another on condition of marriage, to appreciate the significance of the recent shift in the law to use a strict, no-fault approach in resolving engagement ring disputes, and to understand the federal tax implications of engagement gifts.

## ENDNOTES

<sup>1</sup> Elaine Marie Tomko, J.D., Rights in Respect of Engagement and Courtship Presents When Marriage Does Not Ensue, 44 A.L.R.5th 1 (1996).

<sup>2</sup> Malasarte v. Keye, 13 Alaska 407, 410 (D. Alaska 1951); Boydston v. Loveless, 890 P.2d 267, 269 (Colo. Ct. App. 1995); Piccininni v. Hajus, 429 A.2d 886, 888 (Conn. 1980); Gill v. Shively, 320 So.2d 415, 416 (Fla. Dist. Ct. App. 1975); Harris v. Davis, 487 N.E.2d 1204, 1205 (Ill. App. Ct. 1986); Linton v. Hasty, 519 N.E.2d 161, 162 (Ind. Ct. App. 1988); Glass v. Wiltz, 551 So.2d 32 (La. Ct. App. 1989); Grossman v. Greenstein, 155 A. 190, 191 (Md. 1931); DeCicco v. Barker, 159 N.E.2d 534, 535 (Mass. 1959); In re Estate of Lowe, 379 N.W.2d 485, 486 (Mich. Ct. App. 1985); Smith v. Smith, 797 S.W.2d 879, 881 (Mo. Ct. App. 1990); Gikas v. Nicholis, 71 A.2d 785, 786 (N.H. 1950); Asante v. Abban, 501, 568 A.2d 146, 149 (N.J. Super. Ct. 1989); Virgil v. Haber, 888 P.2d 455, 457 (N.M. 1994); Lowe v. Quinn, 318 N.Y.S. 467, 468 (N.Y. App. Div. 1971); Kohler v. Flynn, 493 N.W.2d 647, 649 (N.D. 1992); Wilson v. Dabo, 461 N.E.2d 8, 9-10 (Ohio Ct. App. 1983); Fanning v. Iversen, 535 N.W.2d 770, 773 (S.D. 1995); Shaw v. Christie, 160 S.W.2d 989, 991 (Tex. Ct. App.

1942); *Williamson v. Johnson*, 20 A.279, 281 (Vt. 1890); *Pretlow v. Pretlow*, 14 S.E.2d 381, 388 (Va. 1941); *Spinnell v. Quigley*, 785 P.2d 1149, 1150 (Wash. Ct. App. 1990); *Bryan v. Lincoln*, 285 S.E.2d 152, 153 (W.Va. 1981); and *Brown v. Thomas*, 379 N.W.2d 868, 872 (Wis. 1985).

<sup>3</sup> *Heiman v. Parish*, 942 P.2d 631, 634 (Kan. 1997); *Fierro v. Hoel*, 465 N.W.2d 669, 671 (Iowa Ct. App. 1990); *Gikas*, 71 A.2d at 786; *Sloin v. Lavine*, 168 A. 849 (N.J. Super. Ct. 1933); *Beck v. Cohen*, 262 N.Y.S. 716, 718 (N.Y. App. Div. 1933); *McIntire v. Raukhorst*, 585 N.E.2d 456, 457 (Ohio Ct. App. 1989); and *Brown*, 379 N.W.2d at 872.

<sup>4</sup> *Crowell v. Danforth*, 609 A.2d 654, 656 (Conn. 1992); *Linton*, 519 N.E.2d at 161-62; *Lafontain v. Hayhurst*, 36 A. 623, 624 (Me. 1896); *Grossman*, 155 A. at 191; *Gikas*, 71 A.2d at 786; *Albanese v. Indelicato*, 51 A.2d 110, 110-11 (N.J. Super. Ct. 1947); and *Beck*, 262 N.Y.S. at 717.

<sup>5</sup> *Albanese*, 51 A.2d at 110-11 (There being no express condition of marriage imposed on the gift of a dinner ring, it need not be returned; a dinner ring given after the parties become engaged is an entirely different matter than the engagement ring given on the occasion of the couple's engagement, the dinner ring having no symbolic meaning beyond the love and affection which the donor bore for the donee.) See *Fortenberry v. Ellis*, 217 So.2d 792, 794 (La. Ct. App. 1969) (A gift combining engagement, Christmas and birthday was not based on condition of marriage and did not have to be returned.)

<sup>6</sup> *Gill*, 320 So.2d at 416; *Vann v. Vehrs*, 633 N.E.2d 102, 106 (Ill. App. Ct. 1994); *Fierro*, 465 N.W.2d at 671-72; *Daigle v. Fournet*, 141 So.2d 406, 408 (La. Ct. App. 1962); *Lowe*, 379 N.W.2d at 486; *Beberman v. Segal*, 69 A.2d 587, 587-88 (N.J. Super. Ct. 1949); *Wilson v. Riggs*, 276 N.Y.S. 232, 332-33 (N.Y. App. Div. 1934), *aff'd per curiam*, 196 N.E. 584 (1935); *Lyle v. Durham*, 473 N.E.2d 1216, 1218 (Ohio Ct. App. 1984); and *Ruehling v. Hornung*, 98 Pa.Super. 535, 538 (1930).

<sup>7</sup> *Coconis v. Christakis*, 70 Ohio Misc. 29 (1981); *Simonian v. Donoian*, 215 P.2d 119, 120 (Cal. Ct. App. 1950); *In re Marriage of Heinzman*, 596 P.2d 61, 63 (Colo. 1979); *White v. Finch*, 209 A.2d 199, 201 (Conn. Cir. Ct. 1964); *Schultz v. Duitz*, 69 S.W.2d 27, 30 (Ky. 1924); *Lowe*, 379 N.W.2d at 486; *Beberman*, 69 A.2d at 587-88; *Beer v. Hart*, 274 N.Y.S. 671, 672 (N.Y. App. Div. 1934); *Spinnell*, 785 P.2d at 1150; and *Bryan*, 285 S.E.2d at 155.

<sup>8</sup> *Shaw v. Shaw*, 38 Cal. Rptr. 520, 522 (Cal. Ct. App. 1964); *Heinzman*, 596 P.2d at 63; *Piccininni v. Hajus*, 429 A.2d 886, 888 (Conn. 1980); *McElroy v. Gay*, 22 So.2d 154, 155 (Fla. 1945); *Harris v. Davis*, 487 N.E.2d 1204, 1206 (Ill. App. Ct. 1986); *Douthitt v. Applegate*, 6 P. 575, 580 (Kan. 1885); *Schultz*, 69 S.W.2d at 29; *Ricketts v. Duple*, 177 So. 838, 840 (La. Ct. App. 1938); *DiCicco v. Barker*, 159 N.E.2d 534, 535 (Mass. 1959); *Lowe*, 379 N.W.2d at 486; *Sloin v. Lavine*, 168 A. 849 (N.J. Super. Ct. 1933); *Hill v. Thomas*, 140 S.W.2d 875, 878 (Tex. Ct. App. 1940); *Williamson v. Johnson*, 20 A.279, 281 (Vt. 1890); and *Lambert v. Lambert*, 66 S.E. 689, 690 (W.Va. 1909).

<sup>9</sup> *Fierro*, 465 N.W.2d at 672; *Heiman v. Parish*, 942 P.2d 631, 636 (Kan. 1997); *Vigel v. Haber*, 888 P.2d 455, 457 (N.M. 1994); *In re Wilson*, 210 B.R. 544, 545 (Bankr. N.D. Ohio 1997); *Lindh v. Surman*, 742 A.2d 643, 645 (Pa. 1999); *Brown v. Thomas*, 379 N.W.2d 868, 872 (Wis. 1985); *Gagliardo v. Clemente*, 580 N.Y.S.2d 278 (N.Y. App. Div. 1992); *Lyle*, 473 N.E.2d at 1218; and *McIntire v. Raukhorst*, 585 N.E.2d 456, 458 (Ohio Ct. App. 1989).

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- <sup>10</sup> McIntire, 585 N.E.2d at 457, and Aronow v. Silver, 538 A.2d 851, 854 (N.J. Super. Ct. 1987).
- <sup>11</sup> Lyle, 473 N.E.2d at 1217; Aronow, 538 A.2d at 852; and Albanese v. Indelicato, 25 N.J. Misc. 144, 145 (1947).
- <sup>12</sup> Vigil, 888 P.2d at 456; and Lindh, 742 A.2d at 646.
- <sup>13</sup> Fanning v. Iversen, 535 N.W.2d 770, 775 (S.D. 1995); Shaw v. Christie, 160 S.W.2d 989, 991 (Tex. Ct. App. 1942); Lambert, 66 S.E. at 690; McElroy, 22 So.2d at 155; Guffin v Kelly, 14 S.E.2d 50, 55 (Ga. 1941); and Hill, 140 S.W. at 878.
- <sup>14</sup> Grossman v. Greenstein, 155 A. 190, 191 (Md. 1931), and Levy v. Gersten, 94 N.Y.S.2d 484, 486 (N.Y. App. Div. 1949).
- <sup>15</sup> Grossman, 155 A. at 191. Contra Simonian v. Donoian, 215 P.2d 119, 121 (Cal. Ct. App. 1950) (The rule requiring the return of engagement gifts if the marriage fails to occur applies only to the engaged couple, and has no application to donors who are not a party to a contemplated marriage.)
- <sup>16</sup> Hooven v. Quintana, 618 P.2d 702, 703 (Colo. Ct. App. 1980); Lowe v. Quinn, 318 N.Y.S.2d 467, 468-69 (N.Y. App. Div. 1971), and Morgan v. Wright, 133 S.E.2d 341, 343 (Ga. 1963).
- <sup>17</sup> Hooven, 618 P.2d at 703; Armitage v. Hogan, 171 P.2d 830, 837 (Wash. 1946); Adams v. Jensen-Thomas, 571 P.2d 958, 960 (Wash. Ct. App. 1977); and Malasarte v. Keye, 13 Alaska 407, 411 (D. Alaska 1951). See Hempy v. Green, 1990 WL 72607, 3 (Ohio Ct. App. 1990) (Donor who provided \$6,000 to facilitate the divorce of the donee was not entitled to recover the engagement gift, neither party having "clean hands" required to obtain an equitable remedy).
- <sup>18</sup> Witkowski v. Blaskiewicz, 615 N.Y.S.2d 640, 642 (N.Y. App. Div. 1994), and Shoenfeld v. Fontek, 324 N.Y.S.2d 487, 489 (N.Y. App. Div. 1971).
- <sup>19</sup> McElroy v. Gay, 22 So.2d 154, 155 (Fla. 1945); Bennedict v. Flannery, 189 N.Y.S. 104, 105 (N.Y. App. Div. 1921); and Gindin v. Silver, 242 A.2d 354, 355 (Pa. 1968).
- <sup>20</sup> Stromberg v. Rubenstein, 44 N.Y.S. 405, 405-406 (N.Y. App. Div. 1897); Gindin, 242 A.2d at 355; and Yubas v. Witaskis, 95 Pa.Super. 296, 298 (1928).
- <sup>21</sup> Ruehling v. Hornung, 98 Pa.Super. 535, 538 (1929) ("Such a ring is given as a pledge or symbol of the contract to marry. We think that it is always given subject to the implied condition that if the marriage does not take place either because of the death, or a disability recognized by the law on the part of either party, or by breach of contract by the donee, or its dissolution by mutual consent, the gift shall be returned. It only becomes the absolute property of the recipient if the marriage takes place.") See Hahn v. U.S., 535 F.Supp. 132, 138-39 (S.D. D.C. 1982) (Because the marriage was prevented by the negligence of the defendant, who thereby became responsible for breaking the engagement, the defendant no right to recover the ring, and the representatives of the decedent-fiancée's estate were entitled to either the diamond ring or its value.)
- <sup>22</sup> Cohen v. Bayside Federal Sav. & Loan Assoc., 309 N.Y.S.2d 980, 984 (N.Y. App. Div. 1970) (the donee may keep the engagement ring, which is a hollowed symbol of the love and devotion that a prospective husband and

wife bear for each other, unless there is a demonstration the surviving fiancée did something to prevent the marriage of the parties); *Urbanus v. Burns*, 20 N.E.2d 869, 871 (Ill. App. Ct. 1939), and *In re Estate of Lowe*, 379 N.W.2d 485, 486 (Mich Ct. App. 1985) (The inability to perform the condition of marriage was due to death, not a termination of the engagement; hence, plaintiff donor had no right to reclaim the ring).

<sup>23</sup> *Mack v. White*, 218 P.2d 76, 78 (Cal. Ct. App. 1950); *McElroy*, 22 So.2d at 154; *Hofferkamp v. Brehm*, 652 N.E.2d 1381, 1386 (Ill. App. Ct. 1995); *Douthitt v. Applegate*, 6 P.575, 577 (Kan. 1885); *Web v. Bittner*, 75 Pa. D&C 54 (York Co. 1950); *Anderson v. Goins*, 187 S.W.2d 415, 417 (Tex. Ct. App. 1945); and *Bryan v. Lincoln*, 285 S.E.2d 152, 153 (W.Va. 1981).

<sup>24</sup> *Gerald v. Costin*, 215 P. 1011, 1013 (Kan. 1923).

<sup>25</sup> Alabama, California, Colorado, Florida, Illinois, Indiana, Maine, Maryland, Massachusetts, Michigan, Nevada, New Hampshire, New Jersey, Pennsylvania, and Wyoming. See Jack L. Rappeport, *Domestic Relations, 1957-58 Survey of Pennsylvania Law*, 20 U. of Pittsburgh L.R. 197, 433, n. 4, and 12 Am.Jur.2d, *Breach of Promise*, §§ 18-20.

<sup>26</sup> *Norman v. Burks*, 209 P.2d 815, 817 (Cal. Ct. App. 1949); *In re Marriage of Heinzman*, 596 P.2d 61, 64 (Colo. 1979); *Piccininni v. Hajus*, 429 A.2d 886, 887 (Conn. 1980); *Gill v. Shively*, 320 So.2d 415, 417 (Fla. Dist. Ct. App. 1975); *Vann v. Vehrs*, 633 N.E.2d 102, 104 (Ill. Ct. App. 1994); *Waddell v. Briggs*, 381 A.2d 1132, 1136 (Me. 1978) (the court expressed no view about whether heart the balm statute barred an action for restitution of property given on condition to marry); *Gikas v. Nicholis*, 71 A.2d 785, 786 (N.H. 1950); *Aronow v. Silver*, 538 A.2d 851, 854 (N.J. Super. Ct. 1971); *Lowe v. Quinn*, 318 N.Y.S.2d 467, 469 (N.Y. App. Div. 1971); *Wilson v. Dabo*, 461 N.E.2d 8, 10 (Ohio Ct. App. 1983); *Pavlicic v. Vogtsberger*, 136 A.2d 127, 130 (Pa. 1957); *Fanning v. Iversen*, 535 N.W.2d 773, 774 (S.D. 1995); *Bryan v. Lincoln*, 285 S.E.2d 152, 153 (W.Va. 1981); and *Brown v. Thomas*, 379 N.W.2d 868, 872 (Wis. 1985).

<sup>27</sup> I.R.C. § 61(2001).

<sup>28</sup> I.R.C. § 102 (2001).

<sup>29</sup> *Comm. v. Duberstein*, 80 S.Ct. 1190 (1960).

<sup>30</sup> *Farid-Es-Sultaneh v. Commissioner of Internal Revenue*, 160 F.2d 812 (2nd Cir. 1947).

<sup>31</sup> I.R.C. §1041 (2001).

<sup>32</sup> I.R.C. §212 (2001).

<sup>33</sup> Alex J. Somppi, Jr., TC Memo 1984-190, PH TCM P 84190, 47 CCH TCM 1519 (1984).

<sup>34</sup> I.R.C. § 2503 (2001).

<sup>35</sup> I.R.C. § 1041 (2001).

<sup>36</sup> I.R.C. § 1001 (2001).

<sup>37</sup> I.R.C. §§ 1221 and 1223 (2001).

<sup>38</sup> I.R.C. § 1001 (2001).

<sup>39</sup> I.R.C. § 1015 (2002).

- <sup>40</sup> I.R.C. § 1012 (2001).
- <sup>41</sup> I.R.C. §§ 1 and 1223 (2001).
- <sup>42</sup> I.R.C. § 1221 (2001).
- <sup>43</sup> I.R.C. § 1222 and 1223 (2001).
- <sup>44</sup> I.R.C. §1 (2001).



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# FRIVOLOUS EMPLOYMENT DISCRIMINATION LITIGATION: MYTH OR REALITY?

**Gerald E. Calvasina, Southern Utah University**  
**Richard V. Calvasina, University of West Florida**  
**Eugene J. Calvasina, Southern University**

## ABSTRACT

*Numerous reports in the popular press have alluded to a rise in the number of frivolous lawsuits being filed in the United States. Employers have lamented for years that the majority of employment discrimination lawsuits have also been frivolous. If these assertions are true, frivolous litigation could be responsible for numerous negative consequences for our legal system and economy.*

*The purpose of this paper is to assess the nature of frivolous litigation and to assess to what extent it is in fact a problem in the context of employment discrimination litigation. The paper focuses on Title VII of the 1964 Civil Rights Act and Americans with Disabilities Act (ADA) court decisions where allegations of frivolous litigation have been raised.*

## INTRODUCTION

Numerous recent reports in the popular press allude to a rise in the number of frivolous lawsuits being filed in the United States and the impact on our judicial system and economy (Abraham, 1998; Winston, 1999; Shapiro, 1999; *Chain Store Age*, 2000; Hayes, 2001). Quotes like, “We have a legal system today that allows a sort of extortion to exist”, and “All too often, terminated employees will retaliate against their former employers by bringing frivolous discrimination lawsuits” are plentiful (Shapiro, 1999; Myers, 1997).

The negative results of frivolous suits are alleged to be numerous. They are reportedly clogging our court systems and lead to judicial delay and high court costs. In addition there are allegations of negative effects on our economy. Groups like Michigan Lawsuit Abuse Watch list negative economic side effects that include the increased cost of Girl Scout cookies and little league baseball insurance, and job-loss in states where expanded liability has decreased productivity and job creation (<http://www.mlaw.org/didyouknow.htm>).

The purpose of this paper is to assess to what extent frivolous litigation is in fact a problem in the context of employment discrimination litigation. The paper focuses on Title VII and ADA court decisions where allegations of frivolous litigation have been raised.

### IS THERE REALLY A PROBLEM?

At the same time the popular press has been raising the volume of the debate on the issue, scholarly publications paint somewhat of a different picture of the situation. Robert G. Bone concluded in his 1997 University of Pennsylvania Law Review article, “We know remarkably little about frivolous litigation. Reliable empirical data is extremely limited, and casual anecdotal evidence highly unreliable”(Bone, 1997). Chris Guthrie, citing the work of Herbert M. Kritzer, noted “the frivolous case debate is sustained primarily through anecdotes” and “there is no evidence of large numbers of frivolous cases involving plaintiffs who sue solely to extort a settlement up to the amount of defendants costs of responding”(Guthrie, 2000).

Bone attributes the lack of empirical work on frivolous litigation to a number of reasons.

*One obstacle is the lack of a clear and generally accepted definition of a “frivolous suit”. Another is the tricky problem of how to determine whether any given suit is frivolous. This problem is particularly acute because the most obvious source of information – judicial determinations of frivolousness – is not likely to represent the case population as a whole, and especially not cases that end in settlement. Finally, researchers cannot easily obtain settlement data because parties often keep settlements confidential, making it very difficult to test ...one of the most serious effects of litigation: the adverse impact on settlement of legitimate suits (Bone, 1997).*

While there is little empirical support for the existence of a plethora of frivolous lawsuits, the perception that it is a problem is wide spread. John Lande’s survey of business lawyers and executives in 1998 reported that 53 percent of inside counsel and 14 percent of outside counsel in his survey believed that more than half of the law suits filed against businesses are frivolous (Lande, 1998). Valerie P. Hans and William S. Lofquist in a 1992 survey of jurors found that 83 percent of jurors in cases involving business defendants either “agree” or “strongly agree” that there are far too many frivolous lawsuits (Hans & Lofquist, 1992).

One of the factors that have helped create this perception is the 1991 Amendments to Title VII of the 1964 Civil Rights Act authorizing compensatory and punitive damages in cases of intentional discrimination. It is well documented in the literature that the number of lawsuits filed in federal courts and complaints filed with administrative agencies increased dramatically in the 1990s. Provisions in the 1991 amendments to Title VII of the 1964 Civil Rights Act authorizing compensatory and punitive damages in cases of intentional discrimination have been identified in the literature as the key force driving the rise in litigation (Armour, 2001; Walker & Lowe, 2001).

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Prior to the 1991 amendments, monetary remedies under Title VII were limited to back pay awards. The 1991 law also extended the damage provisions to the Americans with Disabilities Act.

### FRIVOLOUS EMPLOYMENT DISCRIMINATION AND ATTORNEY FEES

The general rule in the United States with respect to attorney's fees is that in the absence of specific legislation providing otherwise, the litigants must pay their own fees and costs. This is known as the American rule. Congress has provided exceptions to this rule. Section 706 (k) of Title VII of the 1964 Civil Rights Act and Section 505 of the Americans with Disabilities Act authorize a district court in its discretion to allow the prevailing party a reasonable attorney's fee. When the prevailing party is the defendant, the fees can only be awarded to the defendant when the court in the exercise of its discretion has found that the plaintiff's action was frivolous, unreasonable, or without foundation. The U.S. Supreme Court clarified the standard to be used in awarding attorney's fees to prevailing defendants in its *Christiansburg Garment Co. v. EEOC* decision and, it is generally agreed that the standard for prevailing defendants is different from prevailing plaintiffs (*Christiansburg Garment Co. v. EEOC*, 1978). In determining if a case is frivolous, "courts look at whether the case was so lacking in merit that it was groundless rather than whether the claim was ultimately unsuccessful" (Watkins, 1998).

While the Supreme Court points to the "sparse legislative history of 706 (k)" the legislative debates that the court does reference make it clear that congress's intention was to "make it easier for a plaintiff of limited means to bring a meritorious suit". The court also points out that congress wanted to include a deterrent to the bringing of lawsuits without foundation.

*"[From these debates] two purposes for 706 (k) emerge. First, Congress desired to make it easier for a plaintiff of limited means to bring a meritorious suit'....But second, and equally important, Congress intended to deter the bringing of lawsuits without foundation by providing that the prevailing party – be it plaintiff or defendant – could obtain legal fees*

*(Grubbs v. Butz, 1976).*

The Supreme Court in *Christiansburg Garment v. EEOC* also clarified the words utilized by the Second and Third Circuit Court of Appeals in earlier cases dealing with the awarding of attorneys fees to defendants in Title VII cases. In the Third Circuit case, *United States Steel Corp. v. United States*, the court denied a fee award to a defendant that had successfully resisted a Commission demand for documents. The court found that the Commission's action had not been "unfounded, meritless, frivolous or vexatiously brought" (*United States Steel Corp. v. United States*, 1975).

The Supreme Court went further in its *Christiansburg Garment* decision in clarifying how district courts should apply the criteria.

*It is important that a district court resist the understandable temptation to engage in post hoc reasoning by concluding that, because a plaintiff did not ultimately prevail, his action must have been unreasonable or without foundation. This kind of hindsight logic could discourage all but the most airtight claims, for seldom can a prospective plaintiff be sure of ultimate success. No matter how honest one's belief that he has been the victim of discrimination, no matter how meritorious one's claim may appear at the outset, the course of litigation is rarely predictable. Decisive facts may not emerge until discovery or trial. The law may change or clarify in the midst of litigation. Even when the law or the facts appear questionable or unfavorable at the outset, a party may have an entirely reasonable ground for bringing suit*

*(Christiansburg Garment Co. v. EEOC, 1978).*

Subsequent cases where employers have been successful in recovering attorney fees under the criteria established in the Christiansburg Garment Co. decision include *Arnold v. Burger King Corp.*, and (4<sup>th</sup> Cir. 1983) and *Hormel Foods*, 2001. In *Arnold v. Burger King Corp.*, the 4<sup>th</sup> Circuit Court of Appeals concluded that the plaintiff, in this case a black male discharged for persistent harassment of female employees, had brought suit solely to vindicate himself in the eyes of his wife and family. The court cited the fact that a white employee involved in less severe incidents of sexual misconduct than the plaintiff had been discharged previously – a fact known to the plaintiff, and there was no other evidence of past dealings between the plaintiff and defendant that involved racial animus (*Arnold v. Burger King Corp.*, 1983). In *Bugg*, the defendant was awarded attorney's fees from the district court's dismissal of the plaintiff's claims because the plaintiff had been warned by their court appointed legal counsel that the case was wholly lacking in merit (*Bugg v. International Union of Allied Industrial Workers*, 1982). In *Hormel Foods*, the court awarded \$20,000 in fees to the defendant citing the fact that the employee and counsel had completely disregarded "recent Supreme Court interpretations of 'disability' when [an employee] uses corrective measures to mitigate an impairment". The employee failed to oppose Hormel's request to dismiss the suit and continued to pursue the claim even after becoming aware that the claim was frivolous, unreasonable and/or groundless (Jensen, Sam et. al., 2001).

While the *Arnold*, *Bugg*, and *Hormel Foods* cases are clear examples of what the Supreme Court had in mind in its *Christiansburg Garment* decision, numerous other cases where district courts have awarded fees to prevailing defendants have not survived appeal. For example, in *EEOC v. L.B. Foster Co.*, the court reiterated *Christiansburg Garment* with respect to a district court's temptation to engage in "post hoc reasoning" simply because the plaintiff did not prevail.

The 3<sup>rd</sup> circuit also noted further that several courts of appeals have reversed fee awards to prevailing defendants in lawsuits brought by the EEOC where these guiding principles have been misapplied (See for example, *EEOC v. Bruno's Restaurant*, 13 F. 3d 285 9<sup>th</sup> Cir. 1993; *EEOC v. Reichhold Chems., Inc.*, 988 F. 2d 1564, 11<sup>th</sup> Cir. 1993; & *EEOC v. Kenneth Balk & Assocs., Inc.*, 813 F. 2d 197, 8<sup>th</sup> Cir. 1987). The 3<sup>rd</sup> Circuit decision in *EEOC v. L.B. Foster* goes on to further point out that

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*“cases where findings of frivolity have been sustained typically have been decided in the defendant’s favor on a motion for summary judgment or a.... motion for involuntary dismissal. In these cases, the plaintiffs did not introduce any evidence to support their claims*

*(EEOC v. L.B. Foster Company, 1997).*

Two other issues that have been raised with respect to the ability of defendants to recover attorney fees include whether the plaintiff chose to represent themselves and the financial status of the plaintiff. In *McNary v. Clarksdale Public Schools*, the plaintiff represented himself in litigation where he claimed that the school system discriminated against him in terminating him after he had been arrested for rape. He claimed that he was discharged as a result of being accused of a sex crime by a female and thus was discriminated against because he is male. His suit was dismissed by the district court and the 5<sup>th</sup> Circuit Court of Appeals. In denying the school system’s request for attorneys’ fees the district court noted that “an unrepresented litigant should not be punished for his failure to recognize subtle factual or legal deficiencies in his claim” (*McNary v. Clarksdale Public Schools*, 1998). In *Alizadeh v. Safeway Stores Inc.*, a district court award of \$33,750 in attorney’s fees to the defendant was vacated and remanded for reconsideration by the 5<sup>th</sup> Circuit Court of Appeals based on the plaintiff’s limited financial resources and ability to pay (*Alizadeh v. Safeway Stores Inc.*, 1990). The 2<sup>nd</sup> Circuit Court of Appeals reached a similar conclusion in a 1979 case and concluded that “the court below should have ascertained whether, in light of the plaintiff’s ability to pay, a lesser sum assessed would have fulfilled the statute’s deterrent purpose without subjecting him to financial ruin” (*Faraci v. Hickey-Freeman Co.*, 1979).

## STATISTICS

The January 2000 special report by the Bureau of Justice Statistics contained some staggering statistics with respect to lawsuits alleging employment discrimination. The total number of suits filed between 1990 and 1998 involving discrimination in employment, housing, welfare, voting, or other civil rights issues more than doubled from 18,793 to 42,354 and the report concluded that the increase was due largely to the increase in employment cases between private parties (Litras, 2000). Over the same time period, there was also a corresponding increase in the number of cases filed in the U.S. courts of appeal (4,729 in 1990 to 8,466 in 1998) with over half of the increase due to the rise in civil rights appeals dealing with employment matters (Litras, 2000).

The disposition of these suits has also fluctuated. For example, the percentage of suits dismissed has risen from 65.6% in 1990 to 70.9% in 1998. Another interesting trend is the number of cases that are disposed of via a trial. In 1990, 7.8% of all civil rights complaints went to trial with that percentage steadily declining over the period to 4.8% in 1998 (Litras, 2000).

Title VII and ADA complaints filed with the EEOC rose and then stabilized from 1992 through 2001. (See Table 1)

<b>Table 1</b>										
<b>Title VII and ADA</b>										
<b>Charges FY 1992 – FY 2001</b>										
	FY									
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Title VII										
Receipts	55,391	62,811	61,105	62,159	55,388	58,615	58,124	57,582	59,588	59,631
Resolutions	47,014	46,176	43,833	54,464	60,944	62,533	60,888	59,085	57,136	54,549
ADA										
Receipts	1,048	15,274	18,859	19,798	18,046	18,108	17,806	17,007	15,864	16,470
Resolutions	88	4,502	12,523	18,900	23,451	24,200	23,324	22,152	20,475	19,084

Source: EEOC – <http://www.eeoc.gov/stats>

Merit resolutions of those charges also fluctuated over the period, rising early in the period, then declining through 1996 and then steadily rising again through FY 2001 (See Table 2)

<b>Table 2</b>										
<b>Title VII and ADA</b>										
<b>Merit Resolutions of Charges (1)</b>										
<b>FY 1992 – FY 2001</b>										
	FY	FY								
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Title VII	7,400	7,156	6,580	6,051	5,126	6,397	6,982	9,206	11,875	11,708
Percent of Charges Resolved	15.7	15.5	15.0	11.1	8.4	10.2	11.5	15.6	20.8	21.5
ADA(2)	19	1,119	2,219	2,507	2,512	2,948	3,405	3,965	4,835	5,090
Percent of Charges Resolved	21.6	24.9	17.7	13.3	10.7	12.2	14.7	17.9	23.6	26.7

(1) Merit Resolutions are defined by the EEOC as charges with outcomes favorable to charging parties and/or charges with meritorious allegations. These include negotiated settlements, withdrawals with benefits, successful conciliations, and unsuccessful conciliations.

(2) The EEOC began enforcing Title I of the ADA on July 26, 1992 and FY 1993 represents the first full year the EEOC enforced Title I of the ADA.

Source: EEOC – <http://www.eeoc.gov/stats>

While the 1991 amendments to Title VII are cited by most as the primary force stimulating the increases in complaints and lawsuits, a variety of other causes have been mentioned. Included among the rationale for the increases are the assertion that backlash to political correctness and diversity initiatives have heightened sensitivity to these issues and more assertiveness on the part of minorities (Jonsson, 2000). Some critics lament that the increase in cases is not “necessarily about justice” but that the legislation has made it “too risky for companies who deny charges to let cases go to court. Instead, they must agree to large settlements for fear they will have to pay even more if the lawsuit goes before a jury”. The potential large damage awards and the propensity to settle fuels the logic that employers have become “vulnerable targets” (Armour, 2001).

A criticism of the ADA going back to its passage is the ambiguity of the act (Robinson, 1992). U.S. Supreme Court Justice Sandra Day O’Connor reiterated this criticism in a recent address to a group of attorneys where she blamed Congress for recent rulings by the Supreme Court limiting the ADA.

*The sponsors of the ADA were “so eager to get something passed,” they didn’t draft the law with proper attention to detail. As a result, O’Connor continued, “the legislative intent is unclear” (Utah Employment Law Letter (1), 2002).*

Other assertions range from placing blame on our “lawyer-driven society” driving more and more people to “go for the money” to the notion that “America is the kind of country that, when we see a wrong, we try to make it right, and we’ll even try to change a culture, like they did in the South” (Jonsson, 2000).

Critics have also targeted the EEOC over the years as part of the fuel driving the litigation nightmares that many employers claim to endure. Yet looking at the EEOC statistics in Table 3, one could easily conclude that the EEOC has acted as a litigation filter to meritless cases. More than half the charges filed with the EEOC have been found to be without merit by the agency.

For Title VII complaints, throughout the period the EEOC regularly resolved complaints with a finding of no reasonable cause. While this in itself is not a bar to the complainant filing a lawsuit, it could have a deterrent effect on plaintiffs. Whether or not this is accurate is an area for further research in this respect. Yet, the EEOC does act as a screening device and opportunity to settle an employee’s complaint before it ends in litigation. Referring to Table 2, with the exception of 1996, the percentage of merit resolutions has been increasing steadily for both Title VII and ADA complaints over the period. At the same time, EEOC litigation activity has remained relatively stable. Table 4 contains EEOC litigation statistics for FY 1992 through FY 2001. It shows that direct suits that the EEOC files against an employer alleging a claim of employment discrimination, are a relatively small part of the actual litigation pie.

<b>Table 3</b> <b>Resolution of Cases by type</b> <b>No Reasonable Cause (1)</b> <b>FY1992 – FY 2001</b>										
	FY									
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Title VII										
Percent of Charges No Reasonable Cause	61.6	57.5	50.8	53.2	62.9	61.9	62.1	60.3	59.2	58.8
ADA										
Percent of Charges No Reasonable Cause	8.0	32.0	37.8	44.4	55.5	57.5	57.7	57.6	55.8	54.1
(1) No Reasonable Cause – EEOC’s determination of no reasonable cause to believe that discrimination occurred based upon evidence obtained in investigation. The charging party may exercise the right to bring private court action.										
Source: EEOC – <a href="http://www.eeoc.gov/stats">http://www.eeoc.gov/stats</a>										

<b>Table 4</b> <b>EEOC Litigation Statistics</b> <b>FY 1992 – FY 2001</b> <b>Direct Suits</b>										
	FY									
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Title VII	242	260	235	193	106	175	229	324	223	271
ADA		3	34	81	38	80	79	54	24	62
Source: EEOC – <a href="http://www.eeoc.gov/stats">http://www.eeoc.gov/stats</a>										

### RECENT CASES

In recent years there have been indications that judges are cracking down on plaintiffs and attorneys that pursue frivolous lawsuits. The September 28, 2001 edition of the Broward Daily Business Review detailed a series of cases where sanctions were recommended or ordered against plaintiffs and or their attorneys in employment discrimination lawsuits. In a case involving Ocean Spray and one of Broward County’s largest law firms, one of the firms partners could face up to

\$700,000 in sanctions related to what a federal magistrate found to be a frivolous claim of racial discrimination (Kay, 2001). In this case, U.S. Magistrate Barry Garber in his report responding to defendant's attorneys request for sanctions, accused the plaintiffs' lawyer of making "unsubstantiated allegations". The magistrate found after questioning several of the plaintiffs, "that they were not terminated or denied promotion because of their race, and indicated that they were not subject to racial epithets in the workplace."

*...the Plaintiffs' pleadings are replete with factual inaccuracies, most of which were not corrected even after they were pointed out to plaintiffs' counsel by the defense. The court cannot and will not turn its back on the outrageous and highly unprofessional conduct of plaintiffs' counsel in this case (Kay, 2001).*

In another Broward County case, described as "the latest is a series of sanctions recommended or ordered against plaintiff lawyers in employment lawsuits", a federal magistrate judge approved \$600,000 in sanctions against a Fort Lauderdale labor and employment attorney (Kay, 2001).

In a New Jersey case, *New Jersey Lawyer* reported on an attorney's "Rambo" tactics which, unreasonably and vexatiously multiplied the proceedings" in a reverse-discrimination case. The court assessed \$56,885 in attorney's fees and \$2,330.60 in cost against the plaintiff's attorney (Liskow, 2001).

While some courts have been cracking down on frivolous litigation recently, one recent U.S. Supreme Court decision reinforced the low threshold necessary for plaintiffs to survive an employers request to dismiss a case without a trial (*Swierkiewicz v. Sorema N.A.*, 2002). Swierkiewicz, a 53-year old native of Hungary, was fired after having been given a choice by his company of resigning or being dismissed. He sued his company for discrimination based on age and national origin. His case was dismissed by the lower court using a Supreme Court standard known as the "prima facie case" which requires an employee to have a certain amount of evidence to support his discrimination claim. Some other courts had been employing a lower standard, requiring that an employee state only basic facts and allegations in their initial complaint and requiring additional facts and evidence to be gathered through other pretrial fact-finding processes. The Supreme Court adopted the lower standard for employees' pleadings in discrimination cases thus making it more difficult to get cases dismissed early in the process (Utah Employment Law Letter, 2002).

## **DISCUSSION AND IMPLICATIONS FOR EMPLOYERS**

The EEOC has acted as a filter eliminating many frivolous claims before they go to court. While it is impossible to screen out all obviously frivolous cases, - "like that of the professor fired for sexual harassment who blamed his behavior on a sexual addiction", courts will generally dismiss

these cases early in the process (Shapiro, 1999). Employers who feel that they are the victims of frivolous employment discrimination lawsuits have a remedy at their disposal. Section 706 (k) of title VII of the 1964 Civil Rights Act and Section 505 of the Americans with Disabilities Act authorize a district court in its discretion to allow the prevailing defendant to recover attorney fees when the action brought is found to be frivolous, unreasonable, or without foundation, even though not brought in subjective bad faith (*Christiansburg Garment Co. v. EEOC*, 1978). However employers have a heavy burden to carry in order to succeed in recovering fees under 706 (k) or 505. As a result, disgruntled employees and unscrupulous lawyers can exploit the threat of litigation over employers. This will certainly not promote efficient and effective management of the firm's human resources in the long run and may be counter-productive with respect to efforts to promote diversity (Armour, 2001).

The determination of situations where employers can recover is made on a case-by-case basis at the district court level and subject to the usual review processes. Cases where employers have succeeded in their claims of frivolity "have been decided in defendant's favor on a motion for summary judgment or a...motion for involuntary dismissal. In these cases, the plaintiffs did not introduce any evidence to support their claims" (*EEOC v. L.B. Foster Company*, 1997).

While the U.S. Supreme Court recently made it more difficult to get employee suits dismissed early in the process, the court and the EEOC may have provided employers with some relief. In *Buckhannon Board and Care Home v. West Virginia Department of Health and Human Services*, the court limited the ability of plaintiffs to recover attorney's fees when an alleged violation of the ADA was resolved before a trial verdict. Restaurant News claims that this decision "offers hope to restaurateurs who claim that opportunistic lawyers have turned frivolous ADA lawsuits into a cottage industry" (Hayes, 2001). The court's decision limits the awarding of attorneys fees where the plaintiff has failed to secure a judgment on the case's merits or a court-ordered consent decree but has achieved the desired result through a voluntary change in the employer's conduct (*Buckhannon board and Care Home, Inc., et al. v. West Virginia Department of Health and Human Resources et al.*, 2001). EEOC chairperson Cari Dominguez recently announced that the EEOC wants to focus on preventing workplace discrimination and "filing lawsuits is not the first line of defense at EEOC – it is a last resort" (Chen, 2001). Chairperson Dominguez also reiterated the EEOC's commitment to the use of mediation, settlement and conciliation as opposed to litigation as a means of resolving allegations of discrimination.

### SUMMARY AND CONCLUSIONS

Employers that pursue consistent fair and pro-active human resource practices, have competent and experienced legal council, and who conclude that their challenged actions or decisions are consistent with the law, may want to pursue 706 (k) or 505 actions.

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As to the question of whether frivolous employment discrimination litigation is a myth or reality, the evidence would seem to indicate that it is a myth. The lack of empirical support for claims by employers, the large number of cases screened by the EEOC and consistently deemed to be without merit, and the harshness of remedies that courts have imposed on plaintiffs' cases that have been deemed frivolous would seem to support that conclusion.

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## THE WORKPLACE RELIGIOUS FREEDOM ACT: ADA PROBLEMS UNDER A NEW NAME

**Deborah F. Inman, Louisiana Tech University**  
**R. Anthony Inman, Louisiana Tech University**

### ABSTRACT

*A number of problems for American businesses and workers have arisen as a result of the passage of the Americans with Disabilities Act (ADA). There is now a looming potential for similar problems with the introduction of the Workplace Religious Freedom Act (WRFA). While not yet a law, the WRFA has been introduced several times and will probably continue to be introduced until enactment. This paper looks at the problems caused by the ADA and provides detailed speculation as to how the same or similar problems can result from passage of the WRFA.*

### INTRODUCTION

Religious discrimination charges filed with the Equal Employment Opportunity Commission (EEOC) are on the rise. EEOC data reveal that 1,939 charges were filed in the year 2000, up from 1,388 in 1992 ("Religion-Based Charges," 2001). In fact, religious-based discrimination charges are the third fastest growing claim, after sexual harassment and disability (Conlin, 1999). This makes the handling of religious expression in the workplace a volatile issue due to sometimes conflicting legal issues and strongly held personal beliefs (Zachery, 1996). "Under Title VII, employers are required to make a reasonable accommodation for an employee's religious beliefs unless doing so would impose an undue hardship. Although simply stated, the standard is hard to apply" (Levy, 2000). In an attempt to clarify religious accommodation, some members of Congress are attempting to modify Title VII through the passage of the Workplace Religious Freedom Act (WRFA) of 2002 (Gaddy, 2002). Senators John Kerry (D-Massachusetts) and Dan Coats (R-Indiana) and Representative William Goodling (R-Pennsylvania) first introduced WRFA in Congress in 1997 (Baker and Daniels, 2000). The bill failed to pass but was re-introduced in 1998 ("Religious Freedom in the Workplace, 2001). Representative Jerrold Nadler (D-New York) re-introduced the bill in 2000 (Baker and Daniels, 2000), leading to its debate by the House Education & Workforce Committee and the Subcommittee on Employer-Employee Relations (Bill Summary & Status for the 106th Congress, 2001). In May, 2002 the bill was introduced by a bipartisan coalition and subsequently referred to the Committee on Health, Education, Labor and Pensions (Gaddy, 2002). Title VII prohibits workplace discrimination based on race, color,

religion, sex or national origin. Unlike the other Title VII categories, no absolute prohibition exists against discrimination based on religion (Bennett-Alexander and Pincus, 1998). As the law now stands, the employer must reasonably accommodate an employee's religious practices unless the accommodation results in an undue hardship. The U.S. Supreme Court [TWA v. Hardison 432 U.S. 63 (1977)] has defined the term undue hardship as anything more than a minimal effort or expense (Hansen, 1998).

The WRFA, as proposed, consists of these five changes to Title VII (Baker and Daniels, 2000):

The definition of "undue hardship" would be comparable to that found in the Americans with Disabilities Act (ADA); that which is seen as a "significant difficulty or expense."

WRFA would clarify for the courts the considerations defining "significant difficulty or expense." First, the court would question if the employee could not perform the essential function of the job as a result of not being accommodated. Next, the court would consider the cost of accommodation, the number of employees involved and for multi-facility employers, the level of extra administrative and fiscal burden that would result from geographic differences.

In 1977, the U.S. Supreme Court ruled that it would be an undue hardship for an employer if the company had to violate the seniority provision in a union collective bargaining agreement in order to accommodate an employee. Under WRFA, a company may no longer adhere to the seniority provision. Employees would be able to accommodate religious beliefs by exchanging shifts, even if this were in violation of a seniority system.

Currently, an employer may use the undue hardship defense before the company has explored any avenues of accommodation if it can prove that any accommodation will be an undue hardship. In other words, to seek ways to accommodate would be futile. WRFA will disallow the "futility defense."

WRFA will not require companies to pay premium wages or give premium benefits for work given the employee as part of reasonable accommodation.

Like the ADA, potential passage of the WRFA is rooted in good intentions and compassion. However, a growing concern exists among experts that the ADA has hurt the cause of disabled employees more than it has improved their standing in the workplace. Some even see the burden placed on the national economy by the ADA as being at least as great as its benefits (Clegg, 1999). The same potential for damage exists with the WRFA. Essentially, the passage of the WRFA would bring the requirements of undue hardship, resulting from religious accommodation, to the level of those of the ADA, which are much wider in scope. The authors' purpose is not to disparage workplace religious freedom, but rather to show that problems inherent with the ADA will possibly, or even likely, be manifested with the passage of the WRFA. To "make our point" we provide a look at the problems that have resulted from the enactment of the ADA and relate the potential for similar problems resulting from the passage of the WRFA. Based on a review of relevant literature, we have selected eight areas of concern (economic, union, legal, workplace confusion, expanded

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interpretation by the EEOC, unintended consequences, legal shortcomings and backlash) that would seem to be impacted by both laws. From this we draw conclusions and offer some recommendations to employers.

## ECONOMICS

Legal theorists with faith in neoclassical economic principles assert that antidiscrimination laws are inefficient and unnecessary (DeLeire, 2000). In particular, the misapplication of civil rights laws can compromise the efficiency and productivity of business (Stein, 2000). EEOC guidelines interpret the ADA to mean that an employer is called upon to reassign an employee to a vacant position (as a reasonable accommodation), if the employee can no longer perform the essential functions of his/her position, with or without reasonable accommodations (Rolnick, 1999). The guidelines also state that the employee does not need to be the most qualified person for the position. If the employee is minimally qualified, the EEOC suggests that the employer should offer him/her the position (Rolnick, 1999). This is probably not the most productive or efficient alternative for the employer, not to mention possible union problems and resulting problems with morale, teamwork and supervision. In addition, an employer may be required to modify facilities, redefine jobs, revise work schedules, or eliminate nonessential job functions (DeLeire, 2000).

Similarly, accommodating employee requests for days off for religious observances could lower morale and productivity (Hansen, 1998). For some, it would not be a mere occasional occurrence, e.g., Seventh-day Adventists and Orthodox Jews cannot work from sundown Friday to sundown Saturday. Substitution and swapping of work shifts among employees, flexible scheduling, lateral transfers, and changes of job assignments as a part of reasonable accommodation, even when voluntary, limits a business's ability to place the most efficient or most experienced person in a particular job (Levy, 2000). Increased absenteeism might even exhaust the replacement workers and halt production (Levy, 2000).

The EEOC maintains that temporary financial costs, such as premium wages for substitutes, are de minimis and may be required under Title VII (Levy, 2000). The EEOC also does not consider administrative costs incurred to arrange an accommodation to be an undue hardship (Levy, 2000).

## UNIONS

When a disabled person is reassigned as a reasonable accommodation, it may violate a collective bargaining agreement with a labor union. Even if the employer does not normally transfer employees to other positions, under ADA a disabled person would have to be reassigned unless an undue hardship is proven (Stein, 2000). Companies are then torn between observing the law and observing their legal collective bargain agreement.

In *TWA v. Hardison* 432 U.S. 63 (1977), the U.S. Supreme Court held that an employer need not breach a collectively bargained seniority system to accommodate religious observances (Levy, 2000). Under WRFA, this would change. As with the ADA, businesses would be torn between observing the law and honoring their union agreements. This problem has appeared in the past, even before the passage of the WRFA. In *Tooley v. Martin-Marietta Corp.* 648 F.2d 1239 (9th cir. 1981), cert. denied, 454 U.S. 1098 (1981), the courts ruled that Seventh-day Adventists, who are prohibited by their religion from becoming members in or paying dues to a union, must be accommodated despite evidence that other Seventh-day Adventists were union members and that the plaintiff had engaged in some conduct that conflicted with the tenets of his religion (Levy, 2000; Bennett-Alexander and Pincus, 1998). If too many employees choose not to join the union for religious reasons, the union could then attempt to prove undue hardship (Bennett-Alexander and Pincus, 1998). Here again, the employer is caught in the middle.

### LEGALITY

The terms "groundswell of litigious insanity" (Carlino, 2000) and "legal domino effect" (Berman, 1998) have been used to describe the legal activity surrounding ADA. While businesses pay the price for ADA, lawyers are becoming more prosperous, some through filing suits indiscriminately (Freedman, 2000). From July 1992 through 1998, 108,939 charges were filed with the EEOC. Eighty-six percent of these charges were either dropped or investigated and dismissed by the EEOC, but not without imposing opportunity costs and legal fees on employers (DeLeire, 2000).

Hansen (1998) described the WRFA as "opening the litigation floodgates." The previously mentioned *Tooley v. Martin-Marietta Corp.* 648 F.2d 1239 (9th cir. 1981), cert. denied, 454 U.S. 1098 (1981) (Bennett-Alexander and Pincus) shows that firms are already starting to lose ground in court. Actually, some firms may choose to pay rather than fight in court, and with good reason. A 1996 Department of Justice analysis revealed that punitive damages were awarded four times as often in employment discrimination cases than in all cases (Levy, 2000). A waitress for Chi Chi's refused to join the wait staff in singing "Happy Birthday" to customers because her Jehovah's Witness beliefs did not allow her to celebrate birthdays. When told that she couldn't wait tables, she complained to the EEOC who sued on her behalf. Despite their claim that she refused to take another job, such as hostess, Chi Chi's settled for \$53,000.

### CONFUSION

Requests for accommodations are often vague and ill-defined (Sonnenberg, 2000). When dealing with non-physical (e.g., mental) disabilities, who qualifies as having a valid disability? The law has evolved to the point that the inability to get along with others and disruptive conduct may

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qualify one for ADA coverage if blamed on mental disability (McDonald, 2000). Davis (2000) stated "cases involving disability, because they are often not so much about fact as they are about personal and social attitudes, tend to involve the states of mind of the various players in the story." Therefore, judges and juries have to perform a complex and creative act of identification (Davis, 2000).

All of this means that employers must be able to distinguish among the various degrees of impairment in order to determine their legal obligations (Berman, 1998). If an employer guesses wrong, he/she may lose a very expensive lawsuit (Berman, 1998).

Similarly, a new law regarding religious rights at work could result in misunderstanding and confusion. Where does one draw the line between accommodation of religious belief and costly workplace disruptions? Preaching in the breakroom, workplace prayer meetings, attempts to convert employees, distribution of religious literature, reading of religious literature during work time, numerous work breaks for required prayer time, and discussion of religion (Zachery, 1996) are possible causes of disruption in the workplace. In one instance, an employee refused to repair a machine surrounded by pinups (Zachery, 1996). One company conducted a workshop where employees were told to put their job first. An employee maintained that this violated her religious beliefs since it forced her to put material matters over spiritual matters (Zachery, 1996).

Further complicating matters, the courts have reasoned that undue hardship must be based on the present situation and not on anticipated hardship or the possibility of multiple requests for accommodation (Levy, 2000). That is, foreseeable problems don't count or matter (Levy, 2000).

A final confusing issue for the employer is determining the sincerity of one's religious beliefs. How does one know if the beliefs are sincerely held? Is this an appropriate question for an employer to ask? Does sincerity matter? What if an employee uses religious beliefs as an excuse to disguise interests that are purely secular? The burden of proving sincerity is not a heavy one, but the courts do not generally probe too deeply into this (Levy, 2000). Title VII provides no guidance in defining the word "religion" other than that it includes all aspects of religious observance and practice, as well as belief (Bennett-Alexander and Pincus, 1998). It doesn't matter how unorthodox the religion appears, or whether the employer approves of or is even aware of the religion or even if the employee does not belong to a religious organization. All that matters is that the belief is closely held and takes the place of religion in the employee's life (Bennett-Alexander and Pincus, 1998). Under this definition, even atheism can be considered a religion.

### **EXPANDED INTERPRETATION BY THE EEOC**

Through the issuance of guidelines that are in excess of that required by law, the EEOC has attempted to expand the scope of the ADA (Rolnick, 1999). Rolnick (1999) explains that by omitting from its guidelines the background qualification that an "employee must first show that he/she is a qualified individual with a disability who is entitled to an accommodation," the EEOC

is attempting to reverse the burden of proof as set forth by the ADA. Another example is the EEOC's stance that no-fault leave policies, which authorize automatic termination for excessive absences, violate the ADA when applied to disabled workers ("EEOC Spells Out Reasonable Accommodation," 1999). Also, EEOC guidelines state that [despite numerous court decisions to the contrary] in some cases, attendance cannot be considered an essential function of a job (Rolnick, 1999).

The WRFA provides, once again, the opportunity for liberal interpretation of the law by the EEOC, this time through the possible issuance of guidelines far in excess of the intent of WRFA proponents. For example, the EEOC maintains that premium wages, paid as a result of accommodation, should be borne by the employer (Levy, 2000) even though the WRFA may state otherwise.

### UNINTENDED CONSEQUENCES

Economists lament public policies that transfer resources to one group because of what they term "the law of unintended consequences" (DeLeire, 2000). Often these policies harm, rather than help, the intended beneficiaries. Research results infer that this may be true for the ADA. For one thing, a number of major court decisions have been decidedly unfavorable to the interests of the unintended beneficiaries (Hahn, 2000). Also, research has suggested that the ADA explains a decline over time in the employment of disabled individuals (Schwochau and David, 2000). The added accommodation cost of employing the disabled has made those workers relatively unattractive to some firms (DeLeire, 2000). Also, economists at MIT have documented employers' fear of "hiring a lawsuit" (Clegg, 1999) as a result of threats of prosecution from the EEOC and potential litigation from disabled workers (DeLeire, 2000). Since ADA's enactment, employment of disabled men fell by 10.9% as compared to 3.1% for non-disabled men (DeLeire, 2000). Those most affected were young (less experienced), less educated (thus less skilled), and mentally disabled. It appears that ADA may have reduced employment for the disabled as a whole and especially for vulnerable groups (DeLeire, 2000).

Washington, D.C. labor defense attorney, Lawrence Lober, fears that the WRFA would require an employer to honor every employee request for a religious accommodation regardless of the consequences. What if everyone wants Fridays off?

As with the ADA, employers could become wary of hiring those with an obvious religious preference. The EEOC has reported that allegations of workplace bias against Muslims, Arabs and Sikhs has mushroomed since September 11 (News-Star, May 26, 2002) so there may already be one strike against some potential employees. While precluded from asking religious preference on an employment application, prospective employers could have other ways of suspecting a religious affiliation. Conservative dress could arouse suspicions while other clues, such as a yarmulke, Muslim garb or a New Testament in the shirt pocket, are more obvious. Jewelry (pins, rings, or

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necklaces bearing a cross or a Star of David) could be a dead giveaway, as might a distinctive hairstyle (Pentecostal or Rastafarian).

### LEGAL SHORTCOMINGS

There are some legal shortcomings apparent in both the ADA and the WRFA. First of all, there is considerable potential for the legal benefits of ADA to cause problems for non-disabled coworkers. The ADA calls for employers to "reassign an employee to a vacant position as a reasonable accommodation if the employee can no longer perform the essential functions of his or her position" (Rolnick, 1999). What about senior coworkers who would have desired the vacant position? Some employers may be required to modify attendance policies as an accommodation to a disabled worker (Rolnick, 1999). Will current coworkers be allowed the same privileges or will they be forced to adhere to the original policy? An extreme case is seen in an ADA-driven demand, by New York parents, that the local school district ban all peanut products from their local elementary school to accommodate their child's allergy (Berman, 1998). Where does that leave the school system if all children's allergies are accommodated? Clegg (1999) states that "the Justice Department recently-and quite correctly-told a federal court that it 'would have been in error' to instruct a jury that defendants were required only to ensure that the disabled 'were treated the same as all other employees'." This implies preferential treatment for some employees to the exclusion of others.

The WRFA also presents the potential problem unequal treatment through forcing employers to give preference to religious employees to the detriment of other employees. Baxter (2000-2001) states that "the employer need show only a de minimis cost, whereas, a 'significant discriminatory impact' is the necessary threshold to constitute undue burden on...coworkers." Does this mean that "coworkers...have no choice but to work the undesirable shifts passed over by their Sabbatarian [those who observe the Sabbath] colleagues"? Baxter (2000-2001) further states "by restricting the availability of accommodations to religious adherents only, the act clearly respects the establishment of religion in blatant disregard of the rights of other employees and violates the Establishment Clause."

The act also "fails to address issues relating to proselytizing" (Baxter, 2000-2001). At what point does proselytizing become unacceptable in the workplace? Some employees have claimed that they were subjected to a hostile work environment as a result of coworker's attempts to impose their religious beliefs upon them (Zachary, 1996).

Finally, "the WRFA also fails to take into account the possible effect of religious freedom on civil rights" (Baxter, 2000-2001). Can employees use religious beliefs as a basis for refusing to work with gay coworkers, workers of another religion, and atheists or to refuse to attend mandatory programs on gay and lesbian rights?

## BACKLASH

Recently, the ADA has been the subject of a backlash by the public, elected officials and even the courts. Krieger (2000) defines backlash as being about [problems or hostility regarding] "the relationship between a legal regime enacted to effect social change and the system of existing norms and institutionalized practices into which it is introduced." This is basically what we are seeing as a result of ADA enactment.

It is very possible that the backlash associated with the ADA could appear in similar fashion with the passage of the WRFA. How are employers going to react if they see the WRFA as a threat to their autonomy? And how are employees going to react when one employees gets off on his/her Sabbath, depriving another employee of his/her shift preference (Levy, 2000).

## CONCLUSION

Some feel that the burdens the ADA has placed on the nation are at least as great as its benefits (Clegg, 1999). This implies that the ADA's economic impact is national in extent as well as company-related. Based on the comparison of the problems associated with both the ADA and the WRFA, one could reasonably suspect that problems may appear under the guise of "religious freedom." To facilitate comparison, Table 1 displays the ADA problems and possible WRFA problems in succinct form.

In order to spare the consumer, the employer and the nation this "undue hardship" some citizens will most likely feel that the WRFA, in it current form, should not be passed. Psychologist, G.E. Zuriff, warned that the ADA "threatens to undermine our culture's already fragile sense of personal responsibility" (Clegg, 1999). Do we really want to add to that by reopening the proverbial "can of worms" titled (this time, anyway) the Workplace Religious Freedom Act.

<b>Table 1: Similarity of Areas Impacted by ADA and WRFA</b>		
	ADA	WRFA
Economic	Reassignment can be inefficient and unproductive (may not be most qualified for job). Morale, teamwork, supervision may be negatively impacted.	Lower morale and productivity Limited ability to place most qualified person in position. Increased absenteeism. Administrative costs.
Union	Accommodation may violate union seniority agreement.	Reassignment may violate union seniority agreement. Possible undue hardship on union.
Legal	Indiscriminant suits. Costly legal fees	Indiscriminant suits. Costly legal fees.

Confusion	Requests for accommodations are vague. What qualifies as a disability?	Workplace disruptions. Foreseeable problems don't count. Definition of religion? Verification of sincerity?
Expanded interpretation by the EEOC	Attempted reversal of burden of proof. Nullifies excessive attendance violation. Attendance not essential.	Premium wages.
Unintended Consequences	Decline in employment of disabled individuals. Most vulnerable are impacted the most.	Increased absenteeism. Hiring bias
Legal Shortcomings	Fails to consider impact on coworkers Preferential treatment	Fails to consider impact on coworkers Preferential treatment Adverse effect on other civil rights
Backlash	Resentment	Dwindling employer autonomy. Negative impact on other employees.

### RECOMMENDATIONS

The following is a list of recommendations to employers anticipating the WRFA's enactment in some form:

◆	Use proper communication channels (television, radio, newspapers, Internet) to maintain a current knowledge of pending legislation.
◆	Contact your Congressman with your concerns.
◆	Contact the leaders of professional organizations of which you are a member and advise them of the possible ramifications of the WRFA. These individuals or organizations may have influence or be connected with lobbyists.
◆	Urge other employers to review the WRFA.
◆	When explaining this issue to others, maintain respect for their beliefs.
◆	Be proactive. Don't wait until legislation is enacted to address this issue. Make sure that your policies are clearly defined. Notify applicants of [policies] before extending a job offer ("From Beards to Body Piercing...", 2001).
◆	Use common sense. Avoid giving employees due cause for complaints based on religious discrimination.

- ◆ If the law is enacted, proceed with caution and seek the advice of experienced employment counsel (Rolnick, 1999).

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# THE U.S. SUPREME COURT CLARIFIES WHEN TITLE VII DISCRIMINATION CLAIMS MAY BE TIME-BARRED

**Craig B. Barkacs, University of San Diego**  
**Linda L. Barkacs, University of San Diego**

## ABSTRACT

*Whether alleged discrimination in the workplace is actionable may turn on a variety of factors, such as severity, frequency, pervasiveness, context, and the magnitude and timing of an alleged transgression. Procedurally - and before a plaintiff can see the inside of a courthouse, Title VII requires that a party alleging discrimination file an administrative charge with the Equal Employment Opportunity Commission (EEOC) either 180 or 300 days "after the alleged unlawful employment practice occurred." This procedural requirement is critical, given that failure to satisfy it may leave an alleged victim without legal recourse.*

## INTRODUCTION

In the U.S. Supreme Court case of *National Railroad Passenger Corporation v. Morgan*, plaintiff Abner Morgan, Jr., sued the National Railroad Passenger Corporation (Amtrak) under Title VII of the Civil Rights Act of 1964. Morgan alleged that he had been subjected to discrete discriminatory and retaliatory acts and had experienced a racially hostile work environment throughout his employment. Although some of the acts Morgan alleged were discriminatory took place within 300 days of the date he filed his EEOC administrative charge, others occurred earlier. At the trial court level, Amtrak won a motion for summary judgment in part, with the court stating that Amtrak could not be held liable for events occurring outside the 300 day filing period. On appeal, the Ninth Circuit reversed, holding that Morgan could sue on claims that might otherwise be time barred as long as they were "sufficiently related" to incidents that were within the statutory time period or were part of a continuing violation that occurred, at least partially, within the period. On appeal to the U.S. Supreme Court, the issue, as framed by the Supreme Court, was whether, and under what circumstances, a Title VII plaintiff may file suit on events that fall outside the EEOC statutory time period. The vital significance to Morgan and other similarly situated plaintiffs

concerns how much of a discrimination case may a plaintiff put in front of a jury, and how much evidence will they be allowed to hear.

### **DEFINING "UNLAWFUL EMPLOYMENT PRACTICE" FOR PURPOSES OF DETERMINING WHEN THE STATUTE OF LIMITATIONS HAS RUN UNDER TITLE VII**

In order to determine the time limit within which an employee must report an "unlawful employment practice," the employee must understand what constitutes a "practice." In order to illustrate, let us examine two distinct employment scenarios.

#### **Hypothetical #1**

Pamela, a mid-level manager, was asked by her boss Tom to accompany him to an out-of-town business meeting. During the business trip, Tom requested that Pamela come to his hotel room to prepare a presentation. Shortly after Pamela arrived at Tom's hotel room, Tom exposed himself to Pamela and asked her what she was willing to do to move up in the company. Pamela opted to return to her room. Two months later, Tom asked Pamela to go on a "date" with him to discuss her yearly bonus. Eleven months from the escapade in the hotel, Pamela filed a claim with the Equal Employment Opportunity Commission ("EEOC") against Tom and the company for the exposure incident and Tom's request for a "date."

#### **Hypothetical #2**

Tina worked as a customer service representative for a trucking company. Shortly after she was hired, her supervisor, Don, began asking her out on dates. Tina refused, but Don persisted. Tired of being rebuffed, Don and several other males in Tina's department began teasing Tina about being "uptight" and a "prude." Don and others left photos of nude and semi-nude men on Tina's desk. After three years of this treatment, and within two months of receiving the most recent nude male photo, Tina decided she had taken enough abuse. Tina filed a claim with the EEOC against Don and the company for the way she was treated.

In accordance with U.S. Supreme Court precedent, Pamela's claim regarding the exposure incident set forth in hypothetical #1 would likely be barred. Tina, conversely, would almost certainly be deemed to have filed a timely claim under the facts set forth in hypothetical #2, and most likely the court will permit her to sue for treatment she endured over the prior three years. Why the difference? Why is it that Pamela cannot sue for a serious incident that occurred eleven months earlier, yet Tina can sue for arguably less serious acts that occurred over the last three years? The

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cases both turn on the U.S. Supreme Court's definition of "unlawful employment practice." Moreover, the U.S. Supreme Court recently stated that the answer to the questions of what constitutes an "unlawful employment practice" and when has that practice "occurred," "varies with the practice." (National Railroad Passenger Corporation v. Morgan, 122 S. Ct. 2061, 2066).

## **DISCRETE ACTS AS AN "UNLAWFUL EMPLOYMENT PRACTICE" UNDER TITLE VII**

"A party must file a charge of discrimination within either 180 or 300 days of the date that a discrete retaliatory or discriminatory act 'occurred' or lose the ability to recover for it" (National Railroad Passenger Corporation v. Morgan, 536 U.S. , June 10, 2002, Bench Opinion; 42 U.S.C.S. @ 2000e-5(e)(1)). Whether an employee has 180 days or 300 days to file depends upon the state in which the employee is located. In a state having an entity authorized to grant or seek relief with respect to an allege unlawful practice, an employee must file a charge within 300 days of the employment practice (National Railroad Passenger Corporation v. Morgan, 122 S. Ct. 2061, 2066). For purposes of our hypotheticals, we will assume the employee has 300 days in which to file a claim.

In hypothetical #1, Pamela was the victim of two discrete acts. Until the matter was heard by the U.S. Supreme Court in 2002, the Courts of Appeals had taken various approaches to the question of whether acts that fall outside the statutory period for filing charges under Title VII were actionable. In National Railroad Passenger Corporation v. Morgan, the U.S. Supreme Court settled the matter, holding that discrete discriminatory acts are not actionable if time barred, even if related to acts alleged in timely filed charges. In other words, Pamela waited too long to file her claim regarding the exposure incident, despite the fact that Tom later asked her on a "date" to discuss her bonus. Citing a case decided over two decades earlier, the U.S. Supreme Court stated that "by choosing what are obviously quite short deadlines, Congress clearly intended to encourage prompt processing of all charges of employment discrimination." (National Railroad Passenger Corporation v. Morgan at 2070, citing Mohasco Corporation v. Silver, 447 U.S. 807, 825).

In National Railroad Passenger Corporation v. Morgan, plaintiff Morgan argued that Title VII does not require the filing of a charge within 180 or 300 days of each discrete act, but that the language requires that a charge be filed within the specified number of days after an "unlawful employment practice." (National Railroad Passenger Corporation v. Morgan at 2071). In other words, according to Morgan, "practice" connotes an "ongoing violation that can endure or recur over a period of time." (National Railroad Passenger Corporation v. Morgan at 2071, citing Brief for Respondent 25-26). Under Morgan's rationale, the term "practice," as set forth in Title VII, provides a statutory basis for the Ninth Circuit's continuing violation doctrine. (National Railroad Passenger Corporation v. Morgan at 2071). The U.S. Supreme Court, however, flatly rejected Morgan's rationale, opining instead that 42 U.S.C. @2000e-2 explains in great detail the sorts of actions that

qualify, including many "discrete acts." (*National Railroad Passenger Corporation v. Morgan* at 2071).

What about the argument that discrete acts that fall within the statutory period make timely the discrete acts that fall outside the time period? In other words, the plaintiff is not alleging a hostile environment, but is alleging that two or more discrete acts occurred, with at least one occurring within the statutory period to file a claim. Is it not fair to permit the plaintiff to file charges for the acts not within the statutory period, given that a new, non-time-barred act has occurred? This argument was addressed by the U.S. Supreme Court in *United Airlines, Inc. v. Evans*, 431 U.S. 553 (1977)). Plaintiff Evans was a female flight attendant who was forced to resign because she got married. (*United Airlines, Inc. v. Evans* at 555). Evans had worked for United Airlines from 1966 until she got married in 1968. United Airlines "no-marriage policy" was subsequently invalidated under Title VII of the Civil Rights Act of 1964. Evans was then rehired four years later, in 1972, and sued to have her seniority reinstated (*United Airlines, Inc. v. Evans* at hn. 1). Evans alleged that her separation from employment at United Airlines in 1968 was a violation of Title VII and that United Airlines committed a second violation of Title VII by refusing to credit her for seniority prior to her second period of employment beginning in 1972. (*United Airlines, Inc. v. Evans* at 554).

Under these facts, the Supreme Court held that Evans claim was time barred because she was not a party to the case in which the no-marriage policy was found to be discriminatory, nor did she file her own charges with the EEOC within 90 days of her separation (Title VII was later amended to increase the time for filing a charge -- *United Airlines, Inc. v. Evans* at 555, fn.3).

In yet another case, the Supreme Court affirmed its belief that "each discrete discriminatory act starts a new clock for filing charges alleging that act." (See, *Delaware State College v. Ricks*, 449 U.S. 250 (1980)). Ricks had been hired as a faculty member at Delaware State College in 1970. In 1973, the tenure committee recommended that Ricks not be tenured, but agreed to reconsider its decision the following year. In 1974, the committee voted to adhere to its earlier recommendation that tenure not be granted. In June 1974, Ricks was told that he would be offered a one year "terminal" contract that would expire in June 1975. Ricks filed a complaint for national origin discrimination with the appropriate state agency in April 1975 (*Delaware State College v. Ricks* at 254). The district court sustained the College's motion to dismiss the lawsuit as untimely, concluding that the only "unlawful employment action" alleged was the decision to deny tenure. (*Delaware State College v. Ricks* at 254-255). As such, the limitations period began running on the date when Ricks was notified about his "terminal" contract (*Delaware State College v. Ricks* at 255). Ricks appealed and the Third Circuit reversed, holding that the statute of limitations did not begin to run until the "terminal" contract expired in June, 1975 (*Delaware State College v. Ricks* at 255). The appellate court's rationale was that an initial decision to terminate an employee might sometimes be reversed (*Delaware State College v. Ricks* at 256). As such, the Third Circuit reasoned that it would be wrong to expect an employee to resort to litigation until actual termination, and stated:

*"A terminated employee who is still working should not be required to consult a lawyer or file charges of discrimination against his employer as long as he is still working even though he has been told of the employer's present intention to terminate him in the future." (Bonham v. Dresser Industries, Inc., 569 F.2d 187, 192, as cited in Delaware State College v. Ricks, at 255).*

The Ricks case then made its way to the U.S. Supreme Court, where the Third Circuit Court of Appeals was reversed and the trial court's initial ruling was reinstated. The key, according to the Supreme Court, was in identifying precisely what was the "unlawful employment practice" alleged in Ricks' complaint ((Delaware State College v. Ricks at 257). The Supreme Court determined that the only "practice" alleged in the complaint was denial of tenure, which occurred in 1974. At oral argument, counsel for Ricks argued that discrimination motivated the College in both denying Ricks tenure and in terminating his employment in 1975 (Delaware State College v. Ricks at 257, citing Transcript of Oral Argument 25, 26, 31-32). Unfortunately for Ricks, the Supreme Court did not subscribe to his continuing violation theory, given it was not in the actual complaint (Delaware State College v. Ricks at 257). Moreover, the Court reasoned that termination of employment is a "delayed but inevitable consequence of denial of tenure" (Delaware State College v. Ricks at 258). "The proper focus is upon the time of the discriminatory acts, not upon the time at which the consequences of the acts became most painful" (Delaware State College v. Ricks at 257, citing Abramson v. University of Hawaii, 594 F.2d 202, 209 (1979)).

#### **USE OF INCIDENTS OF EXCLUDED "UNLAWFUL EMPLOYMENT PRACTICES" AS EVIDENCE AT TRIAL**

Despite the fact that certain "unlawful employment practices" may be time-barred because they are discrete acts", Title VII does not bar an employee from using such prior acts as background evidence to support a timely claim (National Railroad Passenger Corporation v. Morgan, 536 U.S., June 10, 2002, Bench Opinion). In fact, Federal Rule of Evidence 404(b) specifically permits prior acts evidence that is relevant to an issue other than character, so long as it is necessary and reliable. For example, impeachment is merely one example of an entirely appropriate basis for admitting prior act evidence (United States v. Stockton, 788 F.2d 210, 219, fn.15 (4th Cir. 1986)). In the context of a Title VII matter:

*"...it is well established that evidence of prior acts 'may constitute relevant background evidence in a proceeding in which the status of a current practice is at issue'...Prior act evidence is especially important in a sexual harassment case because the issue for the court is not merely whether there was harassment but whether the harassment was so pervasive or severe as to create an abusive working atmosphere...Recent acts of harassment could take on a harsher and more oppressive reality when considered against a backdrop of prior harassment"* (Clara Sims, et al. v. Montgomery County Commissioner, et al., 766 F.Supp. 1052, 1073 (1990), citing, among others, United Air Lines, Inc. v. Evans at 558 and Meritor Savings Bank, 477 U.S. 57, 67).

**REPEATED CONDUCT AS AN "UNLAWFUL EMPLOYMENT PRACTICE"  
UNDER TITLE VII AND WAIVER, TOLLING AND ESTOPPEL OF CLAIMS FOR  
"UNLAWFUL EMPLOYMENT PRACTICES" UNDER TITLE VII**

In hypothetical #2, Tina was subjected to repeated acts of harassment by Don and other male colleagues in her department. Tina filed her claim with the EEOC within two months of the most recent incident in which a photo of a nude male was put on her desk. Why is it that all of Tina's claim for incidents that occurred within the last three years are timely filed? "Hostile environment claims are different in kind from discrete acts. Their very nature involves repeated conduct" (National Railroad Passenger Corporation v. Morgan at 2073).

*"The 'unlawful employment practice' therefore cannot be said to occur on any particular day. It occurs over a series of days or perhaps years and, in direct contrast to discrete acts, a single act of harassment may not be actionable on its own"* (Harris v. Forklift Systems, Inc., 510 U.S. 17, 21, as cited by National Railroad Passenger Corporation v. Morgan at 2073).

In Harris, the Supreme Court recognized that a workplace "permeated with discriminatory intimidation, ridicule, and insult, that is sufficiently severe or pervasive to alter the conditions of the victim's employment and create an abusive working environment" violates Title VII (Harris v. Forklift at 21). In order to decide whether a claim for workplace harassment is timely filed, the court under Title VII must determine whether the charge was filed within 180 or 300 days "after the alleged unlawful employment practice occurred...A hostile work environment claim is comprised of a series of separate acts that collectively constitute one 'unlawful employment practice'" (National Railroad Passenger Corporation v. Morgan at 2074, citing 42 U.S.C. @ 2000e-5(e)(1)).

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In order to timely file a claim for hostile environment, the plaintiff need only file a charge within the applicable number of days after the unlawful practice happened - as long as an act contributing to the claim occurs within the filing period, the entire period of the hostile environment may be considered by the court " (National Railroad Passenger Corporation v. Morgan at 2074). Moreover, equitable considerations may be taken into account:

*"The filing period is not a jurisdictional prerequisite to filing a Title VII suit. Rather, it is a requirement subject to waiver, estoppel, and equitable tolling 'when equity so requires...These equitable doctrines allow us to honor Title VII's remedial purpose 'without negating the particular purpose of the filing requirement, to give prompt notice to the employer'" (Zipes v. Trans World Airlines, Inc., 455 U.S. 385, 398, as cited by National Railroad Passenger Corporation v. Morgan at 2076.)*

Nevertheless, a potential plaintiff is best served by promptly filing an administrative charge, thereby obviating the possible need to invoke equitable doctrines.

#### **LACHES AS A DEFENSE TO DELAY IN FILING CLAIMS FOR "UNLAWFUL EMPLOYMENT PRACTICES" UNDER TITLE VII**

The Court in National Railroad Passenger Corporation v. Morgan sought to make clear that even though employers may be liable for employment practices that occur outside the limitations period (in the case of hostile work environment claims), employers do have recourse if there is an unreasonable delay in filing a charge (National Railroad Passenger Corporation v. Morgan at 2076).

For example, the Supreme Court has opined that if the EEOC causes an inordinate delay in filing the action after exhausting efforts to settle the case, and the delay results in injury to the defendant employer, the plaintiff "may not be entitled to relief if its conduct of the cause has improperly and substantially prejudiced the other party" (Occidental Life Ins. Co. of Cal. V. EEOC, 432 U.S. 355, 373 (1977) and Abermarle Paper Co. v. Moody, 422 U.S. 405, 424 (1975), as cited in National Railroad Passenger Corporation v. Morgan at 2077). Likewise, if the plaintiff employee causes delay, the same principle applies (Abermarle Paper Co. v. Moody at 424, as cited by National Railroad Passenger Corporation v. Morgan at 2077).

In essence, a defendant employer may raise a laches defense, barring maintenance of a lawsuit for unreasonable delay in filing which results in damage to the defendant (National Railroad Passenger Corporation v. Morgan at 2077). To prove laches the defendant must demonstrate that the plaintiff lacked diligence and that as a result, there was prejudice to the party asserting the defense

(*Kansas v. Colorado*, 514 U.S. 673, 687 (1995), as cited by *National Railroad Passenger Corporation v. Morgan* at 2077).

### CONCLUSION

In summary, the Supreme Court's dichotomous decision in *National Railroad Passenger Corporation v. Morgan* turns on the nature of the claims being made. For discrete discriminatory and retaliatory practices, the clock starts ticking on the date of occurrence, and application of the time periods for filing with the EEOC will be strictly enforced. For hostile work environment claims, which by their very nature tend to encompass many events and often occur over a protracted period of time, each single event connects with all the others. Or as the Supreme Court put it, "[t]he statute does not separate individual acts that are part of the hostile environment claim from the whole for purposes of timely filing and liability" (*National Railroad Passenger Corporation v. Morgan* at 2075).

To illustrate this point concerning hostile work environments, the Court offered the following scenarios:

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|----|---|
| 1. | Acts on days 1-400 create a hostile work environment. The employee files the charge [with the EEOC] on day 401. Can the employee recover for that part of the hostile work environment that occurred in the first 100 days?   |
| 2. | Acts contribute to a hostile environment on day 1-100 and on day 401[at which time a charge with the EEOC is filed], but there are no acts between days 100-400. Can the act occurring on day 401 pull the acts in for the purpose of liability? ( <i>National Railroad Passenger Corporation v. Morgan</i> at 2075). |

Both of the foregoing scenarios turn out to be legally identical in terms of constituting "one unlawful employment practice" (i.e., a "hostile work environment"). And, likewise, in both cases the employee will have filed a timely charge with the EEOC on day 401 that will serve to bring in all of the previous related acts. The distinction made by the Supreme Court, and its significance, is that each discrete unlawful employment practice has its own discrete filing period that must be satisfied, while a hostile work environment is an unlawful employment practice unto itself that starts the clock running with the last related act that is part of the hostile work environment. Understanding this distinction and operating within its constraints will ultimately determine how much of a discrimination case a plaintiff may put in front of a jury, and how much evidence the jury will be permitted to hear.

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- 42 U.S.C.S. @ 2000e-5(e)(1).



# **ETHICAL ISSUES**

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# FROM ESSENTIAL CHARACTERISTIC TO OXYMORON: ACCOUNTING ETHICS UNDER THE GUN

**Martha Lair Sale, University of South Alabama**  
**Ryan Samuel Sale, University of New Orleans**  
**Ronald G. Cheek, University of Louisiana at Lafayette**

## ABSTRACT

*In the aftermath of recent scandals representatives of the accounting profession and other groups intent on protecting both the profession and the public are trying to determine a course of action that will influence accounting professionals to follow the high levels of moral behavior that contribute to the value of the accounting function. In choosing a course of action these groups must consider that ethical reasoning is a learned skill. They must also consider the avenues available that may exert an influence on ethical reasoning and thus on ethical behavior. These influences fall into three broad categories characterized as personal influences, normative influences, and punitive influences. An examination of what has how accounting scandals have developed and what been established about moral reasoning and moral behavior suggests that punitive influences are ineffective in assuring ethical behavior. Since personal influences are believed to be established rather early in life, this paper suggests that normative influences are the best mechanism for influencing the ethical behavior of accountants.*

## INTRODUCTION

Enron-the very name evokes visions of fraud and corruption. The greatest accounting scandal ever has reduced Arthur Andersen, once characterized as the premier accounting firm in America, to the brunt of bad jokes and caused a scramble of agencies and committees dedicated to restoring the public trust in the accounting profession. The Enron scandal cost investors over \$300 billion dollars and has contributed to a period of investor jitters that left the stock markets reeling. Managers of some of America's top corporations grossly abused the trust placed in them by their investors and society. These abuses were not confined to a hand full of corporate leaders, but were so widespread as to have involved a host of rank-and-file managers and employees. Many of the individuals charged with ethics violations were business school graduates. Administrators and

faculty of business schools have recognized for decades their responsibility to promote an ethical business environment and have debated how best to achieve this end. Undoubtedly, these abuses occurred with the knowledge of employees that were Certified Public Accountants, Certified Management Accountants, and other financial professionals who have sworn to uphold a code of ethics. In addition, these publicly traded companies filed detailed reports that were publicly available and submitted to examination by, supposedly impartial, external auditors who also prescribed to a code of ethics. How could the situations involving Enron, Sunbeam, Waste Management, Xerox, Johnson and Johnson, and scores of other corporations have come about when those responsible for financial stewardship and reporting were supposedly exposed to and sworn to defend a positive ethical or moral environment? Some suggest simple personal greed is the culprit, or claim that the moral climate of business is at fault, others claim the deterioration of societal mores is at fault.

### **ETHICS AS A LEARNED SKILL**

A survey of ethics and morality research reveals several models used in the examination of ethical behavior. These models are based on the cognitive-development school of psychological research, which holds that individuals pass through a series of stages in development toward maturity. Research in this area has taken several divergent forms and has not been dominated by any one model or approach, but central to this entire body of ethics research based in cognitive-development is the assertion that these are learned responses that may be fostered with training.

Kohlberg (1964) defined six theoretical stages of moral development. These stages, from the most immature to the most mature, or advanced, are:

1.	Punishment and obedience orientation (Right is determined by avoiding punishment and not breaking the rules of authority),
2.	Naive instrumental hedonism (Right is determined by one's own self interest with recognition of what is fair to others.),
3.	Good-boy or good-girl morality of maintaining good relations, approval of others (Right is determined by the feelings or expectations of others and the golden rule.),
4.	Authority maintaining morality (Right is determined by ones commitment to the good of society and social order.),
5.	Morality of contract of individual rights and democratically accepted law (Right is upholding the rights and values of others under freely chosen code of moral behavior),
6.	Morality of individual principles of conscience (Right is determined by universal internal ethical principles which supercede laws or conventions).

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Stages 1 and 2 make up the Preconventional Level at which moral values reside primarily in consequences. Stages 2 and 3 make up the Conventional Level characterized by morality arising from commitments and duty to society. The final two stages make up the Post Conventional Level where morality consists of personal commitment to freely selected values. Kohlberg posited that individuals moved up the scale as they matured with few individuals ever becoming ethically developed to the extent that they functioned in the highest stage. Kohlberg himself recognized the evolving nature of the area of morality or ethical research and revised his approach several times. However, the starting point for Kohlberg's examination of morality research was cognition and the personal construction of basic epistemological categories like rights duties and justice (Rest, Narvaez, Thoma & Bebeau, 2000). Building on these concepts Colby and Kohlberg (Colby & Kohlberg, 1987) developed an instrument dubbed the MJI (Moral Judgment Interview) to measure the level of an individual's moral development.

James Rest (1979) developed the Defining Issues Test (DIT) which was a self-administered questionnaire based on the work of Kohlberg (1964). Like Kohlberg, Rest and his associates used cognition and the personal construction of basic epistemological categories as a starting point for the examination of morality, but they built on Kohlberg's idea of the cognitive development of moral judgment and stressed the developmental aspects of moral judgment. Rest et al. (2000) stress the progression of developmental schemas rather than the measurement of distinct stages of development. They postulate three schemas of moral development ranging from the Personal Interest Schema (which incorporates Kohlberg's Stages 2 and 3) through the Maintaining Norms Schema (derived from Kohlberg's Stage 4) to the Post Conventional Schema (derived from Kohlberg's Stages 5 and 6). Results of giving the DIT to thousands of subjects have supported the existence of these three schemas. The Personal Interest Schema has not been well documented using the DIT, but the youngest group with reading skills well enough developed to take the DIT has been adolescents and it is supposed that by this age the individual has developed beyond this stage. The Personal Interest Schema is at a developmental level below the ability to cooperate on a society-wide level so interest in moral judgment and ethical reasoning used in business decisions focuses on the Maintaining Norms Schema and the Post Conventional Schema. The Maintaining Norms Schema represents a normative view of ethics in which the individual is able to recognize and relate to the norms of society and the authority figures responsible for maintaining those norms. Attempts to gain consensus, appeal to established practice or existing authority. The Post Conventional Schema represents a morality based on primacy of moral criteria and appeal to full reciprocity of shared personal ideals. Attempts to gain consensus are based on reciprocated ideals and logical coherence (Rest, et al., 2000).

Fishbein and Ajzen (1975) developed a widely used model of ethical behavior in which the best predictor of behavior is a preceding intention to behave in a certain way. This intention, in turn, has two antecedents, a personal predisposition or attitude toward the behavior (attitudinal influences) and an internalized perception as to the opinions of persons important to the decision maker in

regard to the behavior (normative influences). This model has been widely used and supported. Subsequent studies have indicated that although attitudinal and normative influences are separable, they are not independent. In other words, a subject's attitude toward a certain behavior will affect their perception as to the opinion of persons important to them regarding the behavior (Ryan, 1978; Miniard & Cohen, 1979; Miniard & Cohen, 1983; Shimp & Kavas, 1984; Oliver & Bearden, 1985). The Hunt-Vitell (1986) model is based on the theory that ethical judgments are a function of deontological evaluations in which the essential characteristics of the act itself lead to a determination of whether the act is right or wrong or teleological evaluations in which the consequences of the act is judged to be favorable or unfavorable.

Despite significant differences in these and other models of ethical behavior used widely in ethics research they share certain characteristics. Differences in terminology aside, descriptions of the influences on the ethical decision-making process tend to fall into three categories of influences that will be described for the purposes of this paper as Personal Influences, Normative Influences, and Punitive Influences. Personal Influences are those influences that arise from as personal code of values or the ideals held by the individual and how ones actions might support or be contrary to those ideals. Personal Influences would include elements of Kohlbergs Stages 5 and 6, Rest's Post Conventional Schema, Fishbein and Ajzen's attitudinal influences, and Hunt and Vitell's deontological evaluations. Normative Influences include those influences that arise from societal norms or fear of what individuals or groups that are important to the individual would think about ones actions. Normative Influences include elements of Kohlberg's Stage 4, Rest's Maintaining Norms Schema, Fishbein and Ajzen's normative influences, and Hunt and Vitell's teleological evaluations. Punitive Influences include those influences that arise from a fear of the consequences of ones actions and include Kohlberg's Stages 1, 2 and 3 and Rest's Personal Interest Schema.

### **ETHICS AS A NECESSARY COMPETITIVE ADVANTAGE FOR ACCOUNTANTS**

The tendency to assign guilt by association makes it difficult for any accountant to know how to respond to the recent rash of accounting scandals. Accountants have long been proud of their status as a self-regulated body, and their reputation as the watchdogs of public interest. Whether the accountant attests to the fairness of a lottery drawing or the financial statements of a multinational conglomerate, the very basis of the value of the attest function of accounting is public trust. The machinations and complexity of agency theory aside, accountants know that the value of their services is strongly dependent on the opinion and perception of the public as to the trustworthiness of accountants.

A number of researchers have used various accepted models of moral reasoning to examine the ethical behavior of accountants and accounting students. Ponemon (1990) used the MJI and DIT in his study of how accountant's moral development progresses and concluded that moral reasoning increased from the staff to supervisory level then decreased between supervisory and manager

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levels. Armstrong (1987) concluded that the level of moral reasoning of CPAs were not significantly different from the general adult population. For her comparison, she used the widely accepted Defining Issues Test (DIT) based on responses to several scenarios that pose a moral question (Rest, 1979). The DIT actually measures the percentage of moral reasoning that occurs at Post Conventional Schema level and assigns a P score measure. The higher the P score, the higher percentage of moral reasoning that is performed using the Post Conventional Schema. Three years later, in a study that included examination of factors that influenced their reasoning when making decisions regarding ethical dilemmas, another group of researchers concluded that CPAs were using higher stages of moral reasoning than Armstrong had asserted (Claypool, Fetyko & Pearson, 1990). Sweeney and Fisher (1998) point out that a number of studies have found accountant's levels of moral reasoning to be less advanced than that of college graduates or other professionals. They postulate that since the DIT is used almost exclusively for this research and the DIT measures only the percentage of reasoning that is "principled" rather than rule driven, this makes the results less valid for accountants who might be arriving at exactly the same conclusions using different ethical reasoning schema. They propose this occurs because rules are so important to the practice of accounting. They also report that P scores of the DIT may be distorted by deeply imbedded ideological content not related to ethics. A number of researchers have found the P scores to be related to liberal political ideologies (Sweeney & Fisher, 1998).

These examples, from many studies, illustrate the point that even accounting researchers cannot agree on whether or not accountants have earned a favored position as keepers of the public trust. Perhaps the reason accountants have not been shown to use higher levels of moral judgment is the result of a biased instrument-one that is not sophisticated enough to control for the rule-driven nature of accounting, accountant's tendency to follow a conservative political ideology, or some other influence. However, it remains that if accountants are not perceived to hold to a higher standard of ethics than the general population, then the value of the attest function of accounting is severely impaired.

### **PERSONAL INFLUENCES**

At the highest recognized levels of ethical judgment the individual remains true to the consensus of what represents ethical behavior as defined by shared personal ideals without regard to normative situational influences or fear of reprisal. This level of ethical behavior is represented by Post Conventional Schema (Rest, 1979) and Stage 5 and Stage 6 moral reasoning (1964).

Accountants operating at this level of ethical judgment would refrain from unethical acts because of their personal belief that the act was wrong without regard for the influence of organizations or groups to which they belong or fear of the consequences of committing an act that was illegal or subject to sanctions by an organization to which they belonged.

As pointed out above, it has not been demonstrated conclusively, how accountants compare with other groups on the use of these higher levels of ethical judgment. With further research it might be shown that accountants arrive at ethical solutions by using lower order Maintaining Norms Schema or it might be shown that accountants really do not arrive at ethical solutions as reliably as do other groups. If one accepts that the DIT is able to measure the use of the Post Conventional Schema in the evaluation of moral dilemmas, then one must accept that accountants are lacking in this ability. To fully evaluate the situation and recommend any remediation, it would be necessary not only to determine if accountants are actually deficient in this characteristic, but also determine if this is a desirable characteristic for accountants. If it were to be found that this were a desirable characteristic for accountants then it should be determined whether there is a way to influence development of Post Conventional thinking in accountants.

### **NORMATIVE INFLUENCES**

Educational background, professional training, professional organizations, and the work environment are all normative influences one would expect to affect the moral or ethical decision-making processes of accountants. Gibson and Frakes (1997) found that of CPAs participating in a study of unethical decision-making, none claimed to have ever performed an unethical act. However, of the CPAs surveyed, approximately 33% stated they believed their fellow professionals would perform an unethical act. The percentage of distrust or cynicism falls into place as the 'subjective norm' to which these accountants see themselves belonging. A number of researchers have found that compliance to a subjective norm and perceived expectation to comply may be strong enough to override an individual's personal attitude toward a particular behavior (Miniard & Cohen, 1983; Shimp & Kavas, 1984; Oliver & Bearden, 1985). These findings make it especially important to examine how the subjective norm of the accounting profession might be altered.

The perceptions of organizational members as to organizational practices and procedures that define what is right or wrong within the organization compose the ethical work climate. To maintain an ethical work climate, organizations must institutionalize normative systems that are apparent to organizational members and in doing so organizations become social actors that are at least partially responsible for the ethical or unethical actions of employees (Victor & Cullen, 1988).

Lewis (1989) found that moral development of business people appears to continue after graduation. In responses to fourteen ethical principles, he found significant differences between students, middle managers, and executives. His findings, when related to Kohlberg's stages of moral development or Rest's schema, support the progression in moral development as one advances in one's business career. The implication is that ethical conduct can be influenced by the conduct of superiors and standards of company or industry practice. This supports the conclusion that individuals will make ethical decisions when the environment supports ethical behavior.

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Corporate culture is not a mission statement posted on a wall or placed in an employee manual proclaiming values and vision. It is the values, beliefs and practices expressed by the daily routine of an organization. Corporate culture is often "rooted in unconscious values and norms shared by members of the organization". It is the driver of the organization-guiding employee's thoughts and actions. Often the interview process is not performed merely to hire the most skilled candidate; the process also involves evaluation of 'fit' to the established corporate culture. Evaluations are not based solely on skill development, social development is also monitored. During the assimilation process, the new hire is evaluated for the ability to 'fit into' the corporation (Hagberg & Heifetz, 2000).

CEOs and Boards of Directors, simply because of the growth of bureaucracy, inhibit change in corporate culture. The independent board of directors evolved as the voice and control mechanism of the outside investor. This relationship is necessary for the large public corporations that have been the greatest creators of wealth and employment in the last century to raise the huge amounts of capital necessary for their creation and survival. But as corporate cultures grow ever more bureaucratic and rigid, upper management becomes more remote from operations and boards grow more passive in managing and influencing change within the culture. The development of a career insider is a long and intricate process. Most boards develop close social ties that tend to restrain any type of monitoring function. "The 'club' is formed by boards that allow outgoing chairs to appoint successors and retired chairs to continue to serve on the board. Consciously and unconsciously, expectations are planted within the ranks of the organization and change becomes less likely (Johnson, 1990).

Change in corporate culture is further stifled through the introduction of improvement programs that maintain employees should be meaningfully involved in decision-making involving the vision and goals they are asked to support (Detert, Schroeder & Mauriel, 2000). However, managers often believe disagreements and dissent are signs of an unhealthy organization and silence is preferred over dissent. It is "common for employees to think that speaking up is useless and even dangerous". The paradox is that management professes to welcome input while employees think the opposite is required. The unconscious formation of perception held by an individual regardless of rank is influenced by history of decisions made, formal rules and the need to belong to the team. The unconscious delivery of rules and expectations set forth by management leads to confusion within the organization (Morrison & Milliken, 2000). Research indicates team building often becomes a way of suppressing independence and a way to control participants (Quinn & Reed, 1997).

The most common excuses for participating in unethical practice are: "I was told to do it" and "Everybody's doing it". Adhering to the wishes of a higher authority takes the individual a step back from a difficult situation. The individual no longer feels the pull of responsibility for a decision that was taken out of his hands. We disassociate ourselves from the decision and the resulting behavior when acquiescing to a higher authority. Corporations rely on respect of authority. The power

distance is the extent to which the members of society accept that power in institutions and organizations is distributed unequally. The greater "the power distance" the greater the level of consistency and predictability is within the organization. Such consistency and predictability is looked upon favorably by upper management. Investors do not look favorably upon chaos and disorganization within a corporate structure (Salter & Niswander, 1995). Reducing power distances within an organization should make individuals feel more comfortable questioning the status quo. The individual must feel a personal ability to make a difference within the organization. However, employees do not appear to feel this freedom. According to one study (Morrison & Milliken, 2000) "the most common reason given for not raising these issues (ethics, inefficiencies and poor performance) were that they feared negative repercussions for speaking up, and they did not believe that speaking up would make a difference".

The excuse that "Everybody's doing it" is not limited to the business environment. It is a widely stated belief used to justify unacceptable actions. When it is assumed that everyone is doing it, the individual performing the action does not own responsibility. The theory of consensus formation states that because we live in groups, we become socialized not to question the actions of others. We begin to conform to the norms of the group and after the 'culture' is accepted, it is rarely questioned.

Management must recognize the tendency to conform particularly in times of ambiguity. This phenomenon is defined as uncertainty avoidance. "Uncertainty avoidance is the degree to which the members of society feel uncomfortable with uncertainty and ambiguity". The higher the uncertainty level, the more individuals seek to conform to the group. Management can counteract the phenomenon by defining acceptable behavior clearly and carefully. These expected behaviors are reinforced by management's daily actions. Management cannot let conventional wisdom seep into the culture if it is not ethically acceptable. Power of the individual must be reinforced. Management must dissuade the notion among employees that "someone else will do this if I don't" encouraging instead an attitude of "if I don't do it, than no one else will" (Salter & Niswander, 1995).

Rarely, will individuals speak up without considering their status and future within an organization. Fear that being outspoken will affect their chances for advancement and job security discourage managers from speaking up about ethical concerns (Piderit, 2000). This leads to the conclusion that, for better or worse, employees tend to conform to the existing organizational culture, which is difficult to change. Employees' intentions and perceptions will positively change when the employer demonstrates ethical behavior is desirable.

As more attention is draw to this current crisis, additional study in area of individual responsibility and the individual's reluctance to break from the group is needed. What type of social work environment should accounting promote? It must recognize the accountant's responsibility to formulate responses based on professional judgment with the individual tendency to self-interest?

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Further studies on corporate culture and standards of ethical conduct might convince corporate leaders that "nice guys" do not always finish last.

The accounting profession has given a great deal of attention to the responsibility of professional education and professional organizations as a normative influence on ethical decision-making. Professional organizations such as the AICPA (American Institute of Certified Public Accountants), IMA (Institute of Management Accountants) and IFAC (International Federation of Accountants) formulate and distribute codes of ethical conduct to which members are expected to adhere. Two decades ago, the responsibility of the accounting profession to promote ethical behavior for members and their clients was already a hot topic. In 1976, new laws addressing the responsibility of tax preparers helped spur the AICPA toward a period of self-examination, which led to substantial revisions of its Code of Professional Conduct and the Treadway Commission of 1987. The report of the Treadway Commission directed attention toward perceived inadequacies in accounting education's emphasis on ethics. The AICPA, the AACSB (American Assembly of Collegiate Schools of Business now called AACSB International Association to Advance Collegiate Schools of Business) and the Federation of Schools of Accountancy proposed that ethics be made an integral part of all business degree programs. The large accounting firms responded by funding an American Accounting Association project that encouraged educators to alert students on the ethical dilemmas that would confront them in practice and provide them with a framework for evaluating alternative courses of action. This constituted a significant change in accounting education, which had historically concentrated on technical skills (Burns & Kiecker, 1995).

### **PUNITIVE INFLUENCES**

Punitive results that might affect the ethical decision-making climate of the accountant include sanctions from the SEC, fines, loss of the right to perform certain accounting functions and potentially devastating legal liability (Olazabal & Almer, 2001). In 1976, Congress passed legislation relating to IRC Sec. 6694 that imposed penalties on tax preparers who understated a taxpayer's liability. These actions were taken in response to significant increases in abusive practices by tax preparers, of whom many are accountants. Insider trading and fraud legislation already cover many of the unethical practices in which accountants engage. In the Enron bankruptcy case, accountants were charged with obstruction of justice in pursuit of a related legal action and faced over 700 million dollars in settlements of related lawsuits. By any standard, these are significant punitive sanctions available against the unethical accountant. If they are insufficient to deter unethical behavior, it is hard to imagine more severe penalties being more effective.

## CONCLUSION

Logic does not support a conclusion that additional legislation would be effective to force individuals within a corporation to do the right thing. Moral and ethical dilemmas faced by accountants in today's business environment are not new. Yet, unethical practice seems to be rampant in the last two decades. The best chance to improve accounting ethics appears to be by way of the normative climate of accounting. It is not enough to post a list of standards on the company bulletin board and hope employees will adapt to the rules. It is important for business to recognize the types of influences the employee experiences when faced with a difficult decision to act ethically or unethically. Many employees participate unknowingly in morally questionable activities. Training programs, creation of clear and well-defined guidelines and the establishment of a favorable corporate culture embracing ethics, morality and to some extent individuality are weapons against these negative trends within the business community. The board of directors must take ethical behavior seriously, and demand assurance that all managers and employees act in accordance with the corporate code. Management must communicate expected ethical behavior with a positive reward system. Management must also communicate consequences of engaging in unethical behavior.

Accountants and members of society understand the value of law and believe in its legitimacy. They also feel "they have a strong obligation to obey the law" (Paine, 1994). However, until corporate leaders believe in and enforce the idea that behaving ethically is integral to their success, an unethical environment will continue to exist for accountants.

Accountants must also take their share of responsibility in establishing a culture of ethics. They cannot simply fall prey to the adage of "when in Rome, do as the Romans". They must understand and accept the duties of their employment and live up to high ethical standards. They must work with upper management and the board of directors to establish an environment of trust and support to act in an ethical and moral manner. Even accountants functioning at the lowest level of ethical reasoning, those who would register at the Personal Interest Schema on the DIT or the lower stages, on Kohlberg's MJI be made to realize that any failure to live up to the public trust destroys the value of accounting as a function and thus their value as a professional.

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# THE ROLE OF BUSINESS ETHICS: INCORPORATING VALUES AND ETHICS INTO BUSINESS DECISIONS

**Sarah Pitts, Christian Brothers University**  
**Rob Kamery, Christian Brothers University**

## ABSTRACT

*This paper examines the growing emphasis that colleges and business firms are placing on business ethics, as well as how business ethics inform the lives of those in business. Current views and legislation have only enhanced the significance of ethics codes, making them a crucial part of the corporate landscape. The increasing relevance of the costs of disregarding ethics in business is noted. Emphasis is placed on the importance of stressing business ethics in society, and on effective methods of teaching the concepts to students so that they will carry a strong ethical sense into the business world.*

## INTRODUCTION

Incorporating values and ethics into business decisions have become increasingly important to business people, universities, government, and the public in general. The costs of unethical behavior in business are high and rising, possibly due to new government regulation. Because of the scandalous last decade, the federal government is listening to the public outrage and taking a stronger stance on unethical business practices. Because of recent laws, it is vital for businesses to focus on securing and monitoring sound ethical policies. In addition, pressure is being placed on business schools to ensure that students graduate with a knowledge of ethical principles and the critical thinking skills necessary to analyze and make sound ethical decisions. This paper will examine the role American universities have taken regarding teaching ethics to business students and the implications this holds for students and society at large. A brief discussion of different views regarding business ethics will be presented including the stakeholder theory, stockholder theory, instrumentalism, and the "invisible handshake." This study will focus on some possible reasons why students lack an understanding of business ethics and on how business schools can meet the challenge of educating students on the importance of business ethics.

## **WHAT IS BUSINESS ETHICS?**

Business ethics can be thought of in many different lights, and part of the reason that business ethics has become such a contemporary issue is because it cannot be defined precisely. Although most people have different standards of what is morally justifiable, society generally feels that there are certain values that should be set as the minimum ethical behavior. Most people believe that in order to meet the minimum ethical standards, a business must be honest, obey the law, and not directly infringe on the rights that our society holds as inalienable human rights. This, however, does not exhaust the definition of business ethics that many believe in. Some other ethical issues involve compensation of employees, job security for employees, hiring practices, waste management issues, pollution, and conflicts of interest. Sometimes companies face situations where ethical choices are in opposition to their interests. An example of this could be a logging company doing business in forests around the world. One ethical consideration must be protecting the rain forest from destruction. Environmentalists may propose that the company stop logging completely; however, this may bring up another ethical issue such as the preservation of jobs for loggers. Except where otherwise stated, this paper is primarily concerned with ethical issues that fit in the first category of minimum ethical standards including honesty, compliance to the law, and fairness. This is not to undermine the importance of evaluating the ethical implications of every decision, but it is intended to simplify.

## **ARE BUSINESS ETHICS IMPORTANT?**

There is empirical evidence that illustrates that of the 500 largest corporations in the U.S., two-thirds of them have committed some form of illegal behavior (Gellerman, 1986). This fact, combined with the many publicized accounts of illegal business operations including fraud, insider trading, and unfair hiring practices, has caused government, colleges, and businesses to increasingly focus on the role of ethics in business. The following illustrates some of the steps that these institutions have taken to ensure greater ethical considerations in the future.

In response to the increasing litigation concerning corporations accused of unethical behavior, the federal government passed the Sentencing Guidelines for Organizations in 1991 (56 Federal Register 22762, November). The objective of the guidelines is to encourage ethical corporate behavior by forcing all organizations to create ethics standards, convey these standards to employees, monitor employees, and deal with employees who have violated their corporate ethics standards. In order to help accomplish this goal, the government has allocated funds for three large studies on the effectiveness of corporate compliance programs. These studies should help businesses in researching and developing their individual ethics training and compliance programs. In addition, the Federal Sentencing Guidelines encourage businesses to provide strong and effective ethical policies by taking those policies into account when prosecuting a violation. The message

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from the federal government under these guidelines is clear: If your company is found to have violated a federal law (regarding the environment, workplace safety, or discrimination), the U.S. Attorney General may decide not to prosecute if you had policies and procedures in place to prevent the violation that occurred. Additionally, if you are prosecuted, you will suffer a smaller fine (Bordwin, 1998).

Ethics are important to firms for a variety of reasons, including the legal responsibilities of the executives, costs of violations, and reputation. Executives and managers are often held liable for violations that occurred below them even if they did not know about or condone the situation. This is a major incentive for directors and top management to see that their organization keeps ethical considerations in perspective while making decisions. In fact, a company with an organized and efficient ethics management program will be treated more leniently by prosecutors in the event of a violation. If the company had strong prevention policies and procedures in place, its consequences will not be as harsh (Bordwin, 1998). This essentially rewards directors and top management who are committed to creating an ethical atmosphere, in the event that an unforeseen unethical situation arises. Companies must commit themselves to a high standard of ethics because litigation is very costly to an organization. Consider some recent examples. In July of 1999, there was a judgment against GM of \$4.9 billion due to its failure to recall some cars when GM knew the gas tanks were potentially dangerous (Patricia Anderson et al. v. General Motors Corp., Civ. No. B135147; Cal. Ct. App., 2nd Dist., August, 2001). One tank exploded on impact, causing serious burns to the customer's face and body. GM had documents that stated that its cost analysis showed that dealing with the lawsuits would be cheaper than recalling all of the cars that were dangerous. The jury ruled that GM had acted with extreme carelessness by sacrificing the health of its customers to save money. This bad ethical decision cost GM two-thirds more than its total profit for 1998 (White, 1999). In addition to the cost of the judgment, there was the large expense of hiring legal counsel, the loss of reputation, and the cost of hiring public relations representatives to limit the damage.

Several other large corporations have had similar dilemmas that cost millions or billions of dollars because of ethical shortcomings. A lawsuit alleging that Texaco practiced racial bias cost the company \$176 million to settle (Bari-Ellen Robert et al. v. Texaco, Inc., 979 F. Supp. 185; 94 Civ. 2015 [CLB] S. Dist. N.Y., September, 1997). Home Depot spent \$87.5 million as a result of penalties for not promoting more women (Vicki Butler v. Home Depot, Inc., No. C-94-4335 S1; C-95-2182 S1; N. Dist. Cal., August, 1997). This negative press also causes immeasurable damage to the company's reputation (Bordwin, 1998). The publicity may create ill will from the public and cause a business to lose customers, revenues, and profits. Also, a company seen as unethical may have problems recruiting good employees.

As these scandals unfold, many spectators blame the nation's business schools for allowing students to enter the corporate world lacking an understanding of ethics (Pizzolatto & Bevil, 1996). In the past five to ten years, business schools typically responded to this pressure by requiring a

separate business ethics class or by incorporating a study of business ethics into several other required classes. The objective of integrating ethics into a business school's curriculum is similar to the goals of most other colleges and universities. Most business schools are striving to convince students that ethics are important, cover a range of ethical topics, increase awareness of ethical issues, and provide students with practice making decisions in difficult situations. It is debated that by the time a person reaches college, there is little that can be done to shape their values (Hanson, 1987). The implication may be that some business schools are not teaching a uniform code of ethics, but instead teaching the students how to apply their own moral codes in the decision making process. This implies that college level students must have a code of ethics in order to successfully utilize business ethics classes.

### **ARE ECONOMICS STUDENTS LESS ETHICAL THAN LIBERAL ARTS STUDENTS?**

The phrase "the invisible hand" implies that the market works efficiently when people act in their own interest. It is not by any means telling people to act selfishly, but simply pointing out that business is created because it is in a person's self-interest to go into business and make money. It is hypothesized that because economics students study Adam Smith and his idea of self-interest extensively, they may use Smith's theory of the invisible hand to justify selfishness and disregard for ethics. A study by Hoas and Wilcox (1995) supports the idea that economics has made less progress in teaching ethics than any other discipline. A second study by Pizzolatto (1996) supports those findings.

A similar study compared the opinions of business students to humanities students in an effort to survey which group had a higher sense of personal ethics (Stewart & Felicetti, 1996). In this study, business students scored above humanities students in their levels of personal ethics. Although it is important to note that the sample size of this study was slightly less than 200 students. Another study of over 1,400 students in the U.S. showed that the majority of U.S. business students have strong ethical convictions. No significant differences between students of economics, accounting, marketing, finance, or management were measured. Stewart and Felicetti (1996) also noted that American business students believe ethical principles governing organizations increase the organizations' effectiveness, profits, and rates of return on investment.

### **STAKEHOLDER THEORY OF ETHICS**

Another type of ethical reasoning is named the stakeholder view. This view states that any person or group that comes into contact with an organization has something at stake. Proponents of this theory believe that economic power is a function of many things, including the relationship each of the stakeholders has with the company. The organization can affect stakeholders positively or negatively. This view holds that instead of focusing only on the needs of the shareholders, the

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ethical firm will take into account all stakeholders when making decisions. Interest groups such as labor unions, environmental groups, and consumers are drawn to this view because it validates their interest as much as the interests of stockholders.

Stockholders and managers have been somewhat skeptical of this idea because it takes money and power away from those who finance the company. Why should investors give up their power to people who invest little or nothing in the company? Is the stakeholder view fair? According to Huse & Eide (1996): "Evaluations have shown that large corporations have been able to avoid undue or excessive control by stakeholders."

### **STOCKHOLDER THEORY OF ETHICS**

The traditional idea of ethics in economics is the stockholder theory, which states that management's largest responsibility is to the shareholders of the company. This theory states that if management makes a decision that decreases shareholder's returns, then management has acted unethically. This idea directly contradicts the stakeholder theory of business ethics and may seem harsh, but it is important to note that the shareholders make significant sacrifices for firms. Stockholders not only take financial risk, but in doing so, make the business possible. Without stockholders, many companies would not have the capital to operate. This theory is important in stressing that management needs to be accountable to the shareholders, and it also stresses the needs of stockholders to be compensated for their risk. It is possible that the stockholder view of ethics does not place adequate emphasis on other factors that are important to the firm's success, and it has recently been questioned by many people including conservative economists.

### **THE INVISIBLE HANDSHAKE**

Woller (1996) states that it is necessary to read both of Smith's books, *An Inquiry Into the Nature and Causes of the Wealth of Nations* and *The Theory of Moral Sentiments*, before attempting to analyze his theories. Woller (1996) believes that when these two writings are taken into consideration together they contradict the idea that the term invisible hand condones running a business with only self-interest as a concern. Smith believed that people are influenced not only by self-interest, but also by the combination of their moral sense and their self-interested side.

... all individuals possess a moral sense as well as a self-interested side. He (Smith) believed that human behavior was strongly influenced by this moral sense through certain naturally arising moral sentiments and through the exercise of individual conscience. To Smith, it was these moral tendencies of the individual, together with the moral connection to society that made free markets possible in the first place. As humans' business managers also possess this moral sense... The pervasive existence of managerial discretion and the indeterminacy of the business environment

means that managers cannot avoid making moral choices, even should we desire they not do so (Woller, 1996).

Woller (1996) stresses that firms do have ethical obligations to their owners including the obligation to render profits. In fact, Woller states that it would often be unethical for managers to allocate substantial amounts of money, even if it was for social good, if it significantly reduced shareholders' wealth. "Firms are not charitable institutions or mutual aid societies" (Woller, 1996). When managers make decisions regarding layoffs, plant closings, workplace safety, product safety, or pollution, it is necessary to take more than the stockholders into consideration. Studies of modern businesses support Woller's logic and suggest that firms do not act solely out of pursuit of profits. Repeated studies have shown that firms often forego some profit in order to pursue a variety of other goals including philanthropy in the community, society, and world (Baily & Boyle, 1977; Donaldson & Lorsch, 1983; Herendeen & Schechter, 1977; Monsen, Cheiu, & Cooley, 1968). Woller (1996) contends that purely selfish behavior is incompatible with the market system, and that it is more efficient for firms to cooperate. This idea was coined by the economist Arthur Okun as the "invisible handshake."

### **INSTRUMENTAL VIEW OF ETHICS**

The instrumental view of ethics illustrates that a firm can comply with the highest ethical standards and behave in such a way that would be economically rational. Instrumental ethics states that a firm will contribute to the goal of profit maximization by being an ethical, socially responsive firm. Thus a firm can serve both the stockholders and the stakeholders (Kotter & Heskett, 1992). In fact, the instrumentalist view holds that being unethical is ultimately very costly to the firm (Hill, 1990).

This can be seen in the examples presented in the beginning of this paper regarding GM, Texaco, and Home Depot. For example, a firm that treats employees unethically may deal with issues including high employee turnover. This turnover leads to expensive training, a period of time where new employees are less efficient and make more mistakes, and costly orientations for new employees. It will also see inflated human resources and administrative costs that stem from excessive hiring. These firms will also suffer from low employee morale, which often leads to lower productivity and possible unethical behavior from the employees. This will increase the cost of monitoring employees. Another example that supports the instrumentalist view occurs when a firm practices extreme environmental degradation and suffers from protesters and bad press. In 1998, a group led by the president of an environmental group in Des Moines, Iowa, staged a two-day sit-in around the parking lot of Home Depot, in protest of their foresting practices. This essentially closed the store for two days and gave the company bad press to deal with. Incidents such as these can be seen in respect to other ethical issues including worker safety, fraud, product safety, unfair hiring practices, and sexual harassment.

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Firms such as Target, a division of Dayton Hudson Corporation, have competitive earnings every quarter. They treat their employees well by giving lucrative benefit package and discounts, as well as incorporating ideas such as profit sharing into their employees' paychecks. Their service department is outstanding, they carry quality products, and give over one percent of profits to charity. They have competitive profits every quarter and are looked upon highly in the community. When firms have high ethical standards in place, it saves them money on expensive audits. A recent study found that auditors do incorporate the strength of corporate governance in decisions related to accepting new clients and performing audit testing. For example, auditors reduced the amount of costly substantive testing procedures performed and were more likely to accept a new client when they perceived that management and the board of directors had exercised effective oversight of the reporting process. This suggests that, even from a cost containment perspective, strong corporate governance makes sense (Cohen & Hanno, 1997). Other goods that come from ethical practices include free positive publicity, customer loyalty, a competitive advantage in recruiting the best job applicants, and good morale in the workplace. Although there is little empirical research on the benefits of instrumentalism, the above examples make it possible to see that ethical business may indeed be good business.

### **INVESTING IN BUSINESS ETHICS**

If, as stated previously, ethical business is good business, then when a company decides to set and follow strong ethical policies, it can be looked upon as an investment. According to basic principles in finance, an investment is good if the present value of the cost of the investment is less than the present value of expected returns. The only time an ethical business situation cannot be looked upon as an investment is if it is a one-time deal that will have no effect on the future. In this case there are no future payoffs resulting from ethical behavior and thus no economic incentives to invest in such behavior. The classic example is the "snakeoil" salesperson who passes through town only once.

Since the ideas and goals of business ethics are very abstract, there is no easy way to measure them, but Moeckel (1997) finds it useful and important to make the attempt. The effects of ethics in dollar amounts could be measured in an attempt to get a rough cost estimate and figures that everyone will understand. The costs are classified into prevention costs, appraisal costs, internal failure costs, and external failure costs.

Prevention costs include the cost of designing the initial ethics system, the costs of training each employee, process analysis, and design of monitoring. Appraisal costs consist of the costs of hotlines, audits, and monitors. Internal failure costs measure the cost of employees' failure to comply with ethical standards, lack of teamwork, and low morale. External failure costs involve the costs of litigation, bad press, fines, and a weakened reputation. Moeckel (1997) states that government is in effect manipulating the external failure costs in an attempt to motivate

organizations to dedicate more resources into prevention and appraisal costs. Government is giving huge punishments for external failure costs, and so companies must tackle internal controls to save dollars. Moeckel (1997) suggests increasing appraisal costs, which will in turn increase internal failure costs and decrease external failure costs significantly.

The difficulty in measuring ethical costs is that it is a very inexact science. Also, it is relatively new, and there are few models to demonstrate effective cost analysis. It is possible that a company could have barely any prevention, appraisal, and internal failure costs, and still avoid any major external failure costs. The problem is, however, if there is an external failure in an organization that has made few attempts to curb unethical behavior, the sentencing guidelines will be strict and could basically ruin the organization. It is very dangerous for an organization to focus on cost minimization at this point in time (Moeckel, 1997).

### **HOW TO TEACH AND ENCOURAGE ETHICS**

Can ethics be taught to people who are 20, 30, or 50 years old? Harvard Business School took the position that ethics can indeed be taught to students and business people regardless of age. Piper (1993) stated that when an institution avoids teaching ethics, it is committing a great wrong to the students, faculty, and society as a whole.

A university that refuses to take ethical dilemmas seriously violates its basic obligation to society. A university that fails to engage its members in a debate on these issues and to communicate with care the reasons for its policies gives an impression of moral indifference that is profoundly dispiriting to large numbers of students and professors who share a concern for social issues and a desire for their institutions to behave responsibly (Piper, 1993). Professors attempted to measure where current business students stand in regards to their feelings about the ethical responsibilities of themselves and corporate America. In doing so, they asked a class to go through a series of interviews concerning their views on ethics. They found that not only did the students lack concrete ethical codes, they also did not fully comprehend the ways in which their actions in the workplace would affect society. Piper (1993) believes that students in the 1990s were much less aware of how business ethics shape America. He also noted that these same students had a much stronger grasp on complex theories, analytical reasoning, and difficult quantitative models than past generations of students. Piper (1993) believes that schools have replaced some of the emphasis they placed on business ethics with a greater emphasis on quantitative and analytical skills.

One factor contributing to the decline in ethics among students is the light in which business is viewed. In the past, people were hired by a company and often stayed there ten years, twenty years, or more. In this situation, the firm was viewed as more than a business, workers were loyal to the business, and businesses were loyal to their employees. It was not uncommon for a company to describe itself as a "family" or "community." These words connote an environment where each employee is respected and cared for by all other members of the company. Essentially, the company

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that employed an individual was a piece of his/her identity, and people took more pride in the company they worked for because the actions and reputation of the company reflected on the employees to a larger extent than it does today. Today colder terms such as "team" and "organization" are used to describe the firm. Parks (1993) states that by using a game as a metaphor for business, it may be easier to justify actions that are not necessarily ethical.

The game orientation, like the interpersonal orientation, presumes a limited frame of reference, a circumscribed playing field in which only particular rules apply, and in which certain behaviors may be tolerable that would otherwise be unacceptable. Game metaphors, because they generally do not acknowledge the sobering consequences embedded in most commercial and financial decisions and transactions, ironically serve to insulate the "players" from the implications of their actions in the "real world" (Piper, 1993).

The growing cultural isolation occurring in the United States is possibly contributing to a decline in corporate ethics. Divisions between social classes have gotten stronger with the rise of technology, the lack of high paying manufacturing jobs, and the blooming suburbs. As families move out to the wealthier suburbs, they become isolated from the poor and working classes. They begin to forget that their existence is not independent from the wealthiest CEOs and also the poorest laborers. When this occurs, people lose understanding of those that are different from them. Without adequate understanding of and compassion for the people an organization affects, it becomes difficult to consistently make ethical policy decisions.

What is increasingly shared across economic strata is a form of cultural isolation and a consequent ignorance of one another, of the connections among people, and how in fact, each economic class is interdependent with and profoundly affects the lives of others, both within and beyond natural boundaries. This cultural isolation, which may also be described as a form of provincialism, delimits compassion--the capacity to see (and, if necessary, to suffer) through the eyes of another (Piper, 1993).

The increasing cultural split between commerce and social responsibility has also been blamed for an increase in unethical actions in business. The United States tends to separate religion, the humanities, and family from business. By dividing these subjects, the typical business student sees an action that will increase profits as good business decision independent of the ethical implications. The business sector often feels that there are other institutions such as religious and humanizing groups that are responsible for protecting the values of society. Some people feel that this somehow releases the commercial sector from its obligation to consider the ethical implications of some actions, and thus contributes to a decline in ethics.

Generation X has been characterized as a cynical generation that is unsure of its role in the world. According to Parks (1993), many students in their mid-twenties do not believe that their actions really make a difference. They feel that large social institutions such as government, corporations, and universities are too big to be influenced by them. This has been reflected in college-aged voter turnout, for example. Some of this cynicism can be tied to political scandals such

as Watergate and various scandals in the Clinton administration. Distrust of businesses can be tied to events such as the junk bond scandals, white-collar crime, and disasters such as the Exxon oil spills.

It is not that students in their young twenties do not care about society. In fact, a report by the Carnegie Foundation cited that volunteerism is on the rise. Most young people enrolled in colleges and universities are hopeful about their futures, but cynical about the future of the United States in the aggregate. Therefore it appears to be in a relationship to our connected-collective-common public life, in contrast to their individual lives, that these students have the least hope and feel the least sense of potential competence and efficacy. They are confident about their personal futures, they are not indifferent to "doing good," but most do not yet articulate a vision or strategy by which they believe they could effect significant positive change in our collective life (Piper, 1993).

It is possible that moral development can continue in young adulthood, and especially during the course of professional studies. Parks (1993) recognizes several ways to teach students to incorporate ethics into their lives and has compiled four recommendations on how to address this complex subject in the classroom. Parks endorses the use of the following four steps by colleges and universities to teach ethics in a way in which the students will embrace the importance of acting ethically. Parks suggests creating a "mentoring community" which could be in the form of a class. This group would "welcome and affirm the competence and promise of young adults' lives, while offering a vision on behalf of a larger possibility and an experience of acting together in concert with that vision" (Piper, 1993). One purpose of this group is simply to recognize that as potential business people, they must challenge the existing norms in an attempt to practice ethically guided business. It will make the students aware that when they enter into the corporate world, their decisions will impact many people in either positive or negative ways. The goal is to show the students that they may face opposition to acting ethically in the name of cutting costs and expanding profits, and remind them that they still have a duty to evaluate every situation based on the ethical dilemma that comes up. Parks feels that when students confront this task together it is less overwhelming than if one person faced it alone.

Parks (1993) second recommendation is to allow the students to think critically. This allows students to reject pieces of the current system and encourages them to make their own judgments instead of relying on cultural assumptions. If students practice dissecting the ethical implications of various situations, they will become more conscious of the various effects of decisions. Encouraging them to make their own decisions and take a stand in class will make it easier to discover and voice any ethical objections in the corporate world. This stage encourages students to explore and strengthen their personal values.

Thirdly, Parks (1993) emphasizes being tolerant of the complexity of issues and using the group to sort out the implications of different situations. Parks feels when an individual is faced with conflicting ethical issues, they may be overwhelmed and unable to fully recognize the intricacy

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of the situation. By working in a group, students can sort out the issues without finding them too difficult to handle.

Some so-called ethical thought that is unnecessarily naive is maintained because individuals in isolation can only handle so much. This is an instance in which the consciousness of a "we"-a mentoring community-becomes crucial. When the multifaceted ethical dimensions of managerial decision-making begin to be recognized and engaged by an entire class of students, the complexity that cannot be tolerated by an individual can be accommodated by the whole (Piper, 1993). And last, Piper recommends that students cultivate diverse perspectives. These new perspectives allow students to understand more clearly the ethical issues. If one can see the situation from the eyes of another, one may be able to comprehend the depth of the problem and take steps to remedy the situation or avoid greater problems. This, Piper (1993) argues, is the primary factor in the formation of ethical and effective business people.

Students need to realize that every decision they may make in business may have ethical undertones. In separating these in universities faculty are failing to teach students that ethics is a part of business. It is important that schools realize this. Harvard psychiatrist Robert Coles said: "What faculty are silent about and what they omit send powerful signals to students. Omission is a powerful, even if unintended, signal that these issues are unimportant" (Piper, 1993).

## CONCLUSIONS

Firms and business people are being pressured to exemplify the highest ethical standards and also to create the largest returns for shareholders. In some cases, these goals go hand in hand, but other times businesses are choosing to reduce costs by cutting corners. The dire effects of abandoning business ethics have been seen in the rising number of class action lawsuits against major U.S. companies. These lawsuits are expensive, embarrassing, and indicators that the current system of teaching business ethics in schools and corporations could use some fine-tuning. When an organization violates an ethical standard, it is judged not only by the circumstance of that violation, but also on the design and management of its ethics training programs. This holds strong implications for top management officials as they can be punished for unethical actions that occur at any level of the organization. As ethical behavior becomes increasingly important in business, there is a pressure on colleges and universities to focus on ensuring their students leave with the highest ethical backgrounds. There are conflicting studies about whether business students, and economic students in particular, have incorporated levels of ethics that are consistent with their peers in liberal arts schools. Regardless, students and faculty agree that additional studies in ethics would be beneficial.

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# EXAMINING THE INDIVIDUALISM/COLLECTIVISM QUESTION IN AN INTERNATIONAL ACADEMIC ENVIRONMENT

**Evelyn C. Hume, University of Texas - Pan American**  
**Aileen Smith, Stephen F. Austin State University**  
**Alan B. Davis, City University of Hong Kong**

## ABSTRACT

*This research examines cross-cultural differences in the responses of university students (n = 792) from the United States (US), the Peoples Republic of China (PRC) and Viet Nam (VN). The survey instrument uses ethical dilemmas familiar to the academic environment of the students.*

*General linear model (GLM) analysis of the students' responses was by CULTure, GENder, and a CULT\*GEN interaction term. The results indicated significant differences ( $p < .05$ ) by the CULTure variable on all 26 surveyed dilemmas. Some support for the individualism/collectivism cultural dimension was indicated in the responses. However, in spite of the significant differences indicated in the analysis by culture, correlational analysis of the cultural means indicates a significant correlation between the responses of the two cultures. Significant GENder differences were indicated on 22 of the 26 items. On all 22 dilemmas, the female students supplied the more ethically sensitive responses. This result supports earlier studies where gender differences have been reported. Three of the survey items indicated significance on the CULT\*GEN interaction term.*

## INTRODUCTION

Ethical studies have increased in number over the past few decades. As universities prepare students to enter the workforce, an understanding of the ethical orientation of our students takes on an added interest. Today's students will graduate into an international and multi-cultural work environment. These cultural differences can have an effect on the ethical beliefs and attitudes of the students coming from diverse cultural backgrounds.

The seminal work of Hofstede (1984) lays the foundation for the study of cultural elements in societies. It is Hofstede's individualism dimension that is of interest to this research. Individuals who "live in societies in which the interests of the individual prevail over the interests of the groups (p. 50)" are called individualistic. Those who "live in societies in which the interest of the group prevails over the interest of the individual (p. 50)" are called collectivistic (or low individualistic). From the research reported by Hofstede, the US ranks the highest on the individualism dimension

of all of the 53 countries surveyed; and most of the Asian countries rank in the lower one-third of the countries surveyed.

The purpose of this research is to examine differences in the ethical orientation of university students from an individualistic culture and from a collectivistic culture. An appreciation for cultural characteristics and a better understanding of how cultural attitudes and beliefs act as a "cognitive filter" for societal perceptions and attitudes is a part of the overall understanding of how culture is linked to ethical orientation. Since the cultural tie is the focus of this study, it is the attitudes of the students toward the ethical dilemmas, not the actual behaviors, that will be examined. Because gender differences and their relationship to ethical responses are also studied in ethical research, it will be a secondary focus of this research.

### **LITERATURE REVIEW**

A number of studies have used student subjects to investigate cultural differences based on the individualism dimension between the two global areas of interest. The results of these studies have offered additional validation of the differences between the subjects from the US and the Asian-Pacific area. Singh et al. (1962) found, as predicted by the individualism variable, society-versus self-orientation differences between American and Chinese students. Triandis et al. (1986) reported support for Hofstede's individualism cultural dimension, using students from nine countries. Bond et al. (1982) and Kim et al. (1990) reported support for the individualism dimension when their studies examined reward allocation intentions of students from the US and Asian countries (i.e., Japan, Korea, Hong Kong). Lee and Green (1991) found support for individualism differences when they reported that social pressures played a more important role in the purchase intention responses of Korean students than those of the US students. Chow et al. (2001) reported similar support for the individualism cultural dimension when surveying students from US and Taiwanese universities on their reaction to and satisfaction with high stretch performance standards.

Numerous studies over the last three decades have examined the ethical orientation of university students in the US (Arlow, 1991; Borkowski & Ugas, 1992; Grant & Broom, 1988; Hawkins & Coconougher, 1972; Jeffrey, 1993; Kahalas et al., 1977; Lyonski & Gaidis, 1991; McNichols & Zimmerer, 1985; Pratt & McLaughlin, 1989a; Pratt & McLaughlin, 1989b; Rogers & Smith, 2001; Smith et al., 1998/99). During the last decade, ethical studies have been extended to examine ethical issues in the international academic area (Armstrong, 1996; Brody et al., 1998; Eynon et al., 1997; Goodwin & Goodwin, 1999; Grünbaum 1997; Lyonski & Gaidis, 1991; Mason & Mudrack, 1996; Nyaw & Ng, 1994; Okleshen & Hoyt, 1996; Salter et al., 2001; Stevenson & Bodkin, 1998; Whipple & Swords, 1992; White & Rhodeback, 1992). A national variable has been used in these studies, and diverse methodologies and results have been reported.

Several cross-national or cross-cultural studies using university students as subjects have examined ethical beliefs and attitudes. Generally, research comparing US, Canadian, or Australian

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students to those from Western European countries has not found significant differences. Based on the predominance of the common Anglo-Saxon heritage in these countries, the research results are not unexpected.

Eynon et al. (1996) compared the ethical reasoning ability of accounting students in the US to those in Ireland. The study reported no significant difference in the moral reasoning scores (using Rest's Defining Issues Test) of the accounting students from the two countries. Whipple and Swords (1992) investigated differences in ethical judgments of business students in the US and United Kingdom (UK). The students examined 11 items related to confidentiality, research integrity, conflict of interest, marketing mix issues, and social issues. There were significant differences on only four of the 11 scenarios examined.

Using a scenario-based survey, Stevenson and Bodkin (1998) compared the ethical sensitivity of students in the US and Australia. Students evaluated 20 sales-type scenarios for acceptability and ethical practice. In general, the results indicated very limited differences in the responses of the two groups. Lyonski and Gaidis (1991) compared ethical responses of business students in the US, Denmark, and New Zealand. The students responded to ethical dilemmas related to coercion and control, conflict of interest, physical environment, paternalism, and personal integrity. The overall results indicated no significant differences among the responses of the students from the three countries. Grünbaum (1997) surveyed business students in the U.S. and Finland and found little evidence of differences between them on issues of business ethics in the international business arena. However, a study comparing ethical perspectives of US and New Zealand business students found that U.S. students judged issues of fraud, coercion and self-interest more harshly than did New Zealand students (Okleshen & Hoyt, 1996). Salter et al. (2001) reported a study in which business students in the U.S. and the U.K. were surveyed regarding their attitudes related to academic dishonesty. The researchers found that US students were more likely to cheat than were UK students. However, the overall differences between the two groups were small, supporting Hofstede's earlier work that identifying the cultures as similar on the "uncertainty avoidance" dimension.

A growing number of cross-cultural studies have begun to look at differences in ethical beliefs and attitudes of US groups and various Asian groups. The differences reported in these studies are generally highly significant. Armstrong (1996) examined business graduate students in Australia, Malaysia, and Singapore to determine whether there was a link between ethical perceptions and culture. The significant results support the hypothesis that cultural differences correlate with ethical differences. Nyaw and Ng (1994) surveyed business students in Taiwan, Japan, Hong Kong, and Canada. The research focus was on the respondents' concern for employees' health and safety, tolerance for gender discrimination, attitudes toward questionable practices by their superiors, and reported likelihood of using unethical practices in competitive business situations. Significant differences between the cultures were indicated on all four issues.

Brody et al. (1998) examined cross-cultural differences between US and Japanese students' attitudes related to whistle-blowing on the job. The study found significant differences between the two groups of students regarding their ethical perceptions, especially with respect to the Individualism/Collectivism cultural dimension. White and Rodeback (1992) surveyed graduate business students in the US and Taiwan concerning questionable behaviors in a hypothetical business situation. The results indicated significant differences in the ethical perceptions of US and Taiwanese students.

These studies investigating differences and similarities between students in the US (or other predominately Anglo countries) and other countries with differing languages and cultures have provided valuable insight into the relationship between culture and ethical attitudes and beliefs. For a more complete picture, it is important to continue to examine this relationship and extend it to other populations and ethical topics.

An additional focus of many ethical studies using university students is the potential for gender differences in the data. Over the last two decades, diverse results have been reported based on the gender variable. Some of these studies have indicated significant differences by the gender of the students studied (Betz & O'Connell, 1987; Arlow, 1991; Kohut & Corriher, 1994; Harris & Sutton, 1995; Khazanchi, 1995; Lane, 1995; Smith et al., 1995; Mason & Mudrack, 1996; Malinowski & Berger, 1996). These gender-significant studies report that the female students gave the more ethical responses. However, many other ethics studies have indicated no significant difference by the gender variable (Friedman et al., 1987; Betz et al., 1989; Stanga & Turpen, 1991; Mudrack, 1993; White & Dooley, 1993; Sikula & Costa, 1994; Jones & Kavanaugh, 1996; McCuddy & Peery, 1996). Other studies have indicated limited differences on the gender variable (Stevens, 1984; McNichols & Zimmerer, 1985; Miesing & Preble, 1985; Konovsky & Jaster, 1989; Borkowski & Ugas, 1992; Giacomino, 1992; Ruegger & King, 1992; Vorherr et al., 1995).

Accounting students, specifically, have been the populations surveyed by several ethics studies examining the gender variable. Significant differences by gender were reported by Stanga and Turpen (1991) and Ameen et al. (1996). In both studies, the female accounting students supplied the more ethical responses. By contrast, Kwak and Ortman (1996) reported limited differences on ethical considerations for the gender variable, and Rogers and Smith (2001) reported no significant differences on the gender analysis.

### **OBJECTIVES OF THE STUDY**

The objective of this study is developed using Hofstede's individualism cultural dimension to examine whether there are cultural differences in the responses to academic ethical dilemmas. The individualism/collectivism cultural dimension refers to the way in which individuals of a cultural group have a relatively similar way of considering the importance of values and beliefs, as they apply to the individuals who compose the cultural group. The core meaning of

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individualism/collectivism is tied to the concept of whether group goals are subordinated for individual personal goals (Triandis et al, 1986).

*Individualist cultures . . . emphasize values that serve the self by making the self feel good, be distinguished, and be independent. . . . Collectivistic cultures . . . emphasize values that serve the ingroup by subordinating personal goals for the sake of preserving ingroup integrity, interdependence of members, and harmonious relationships* (Schwartz, 1990, p. 140).

Hui and Triandis found in their examination of international researchers' concept of individualism/collectivism that the concept can be defined in terms of concern. "The more concern one has toward others, the more bonds with others are felt and acted upon, the more collectivistic is the person." (1986, p. 240).

Students from two state universities in the US are used to represent the Individualist culture, and students from two Asian area universities comprise the Collectivistic culture. A secondary focus of the study is to examine whether gender differences, as well as whether there is a culture\*gender interaction, are present in the students' responses.

## METHODOLOGY

Data for the examination were collected with a self-report survey filled out by business students in two US universities and universities in the People's Republic of China (PRC) and Viet Nam (VN). Each survey guaranteed individual anonymity and stated that the respondent had the choice of participating or not participating in the survey without course penalty. Since the data were collected in an intact classroom setting, there was a 100% participation rate. Seven hundred ninety-six surveys were obtained; however, four surveys were too incomplete to use in the analysis, producing 792 surveys for the analysis.

Often ethical surveys request students to respond to scenarios or statements that are outside their knowledge or experience level. Since the target population of the study was students, the study employs a survey instrument designed specifically for students. The survey instrument contains ethical dilemmas appropriate to an academic situation and the students' level of experience.

The questionnaire has two parts. The first part asked the students to respond, on a five-point Likert scale (i.e., 1 = very unethical to 5 = not at all unethical), to questionable ethical dilemmas associated with the academic environment (See the Appendix for the short form of the dilemmas). Students were asked to indicate how unethical they personally believed the 26 academic dilemmas were. The items used in this part of the survey are from a longer questionnaire developed by Cornelius Pratt, who gave permission for their use. The second part of the questionnaire requested

demographic information from the students. Table 1 gives the demographic information for the students from the two cultures.

<b>Table 1 - Respondent Demographics</b>		
Demographic	Number*	Percent
Universities:		
US (a)	203	25.7
US (b)	221	27.9
IDV Culture	424	53.6
PRC	176	22.3
Viet Nam	191	24.1
COLL Culture	367	46.4
Total	791	100.0
Age:		
<19 years	131	16.9
20 years	180	23.2
21 years	244	31.5
22 years	105	13.6
>23 years	115	14.8
Total	775	100.0
Gender:		
Male	333	42.1
Female	459	57.9
Total	792	100.0
*Not all demographics equal 792; some respondents did not answer all of the items.		

The enrollment of the two US universities is reported to be approximately 82% Caucasian and less than one percent Asian (USNews, 2002). The students from the universities in the PRC and VN were surveyed from classes that had 100% domestic enrollment. This high degree of ethnic polarization of the students in the study provides a compelling opportunity to compare the ethical

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beliefs of the two groups. With so few Asians in the US group and no Caucasians in the PRC/NV group, the statistical significance is enhanced.

The English version of the questionnaire was translated into Chinese for the PRC students and into Vietnamese for the Vietnamese students. The translated versions were pilot-tested before their use, and some changes in terminology resulted from the pilot-testing. Examples of changes in terminology include changing the word "exam" to "test," "term paper" to "major writing assignment/term paper," and "college student" to "university student" to present the appropriate phraseology for the survey item consideration.

## ANALYSIS AND RESULTS

The SAS statistical program general linear model (GLM) analysis was used to analyze the 26 specific ethical dilemmas. The mean responses of the students to the questionable behaviors were the predictor variables in the analysis, with CULTure (i.e., individualistic [IDV] or collectivistic [COLL]), GENDER, and an interaction term (i.e., CULT\*GEN) as indicator variables.

Table 2 gives the F-values of the general models for the 26 dilemmas and the F-values for the significant variables for each survey item. The CULT variable was significant ( $p < .05$ ) on all 26 survey items. The GENDER variable was significant on 22 of the 26 items. Three of the interaction terms indicated significance.

### CULTural Variable

The results of the general linear model indicate that the respondents in the IDV group rated the questionable actions as more unethical than did those in the COLL group on 23 of the 26 items. The three items rated more unethical by the COLL group were items No. 9 (Studying from someone else's notes), No. 10 (Visiting a professor after an exam, attempting to bias grading), and No. 12 (Obtaining an old exam from a previous semester or quarter). It is interesting to note that these three items are actions a student might typically take alone to the benefit of only himself or herself. That is, these behaviors are highly inconsistent with the collective society and would likely be viewed as unethical, in part, because the student is serving his or her own interest rather than the interest of the group. The concept that the action does not benefit the group would be less likely to enter into the ethical judgment process of the IDV participants.

The three items ranked most unethical were the same for both cultural groups, but not in the same order, as shown in Table 3. At the top of the list of unethical actions for both groups are No. 22 (Changing a test paper from the original handed in), No. 24 (Having someone take a test or you), and No. 26 (Interfering with another student's work). For the IDV group, the items were ordered 24, 26, 22; for the COLL group they were ordered 22, 26, 24.

Table 2 - GLM Analysis Results ( $\rho < .05$ )						
No.	Model F-value	Model p-value	Significant Variables F-value/p-value			Results <sup>a</sup>
1	6.80	.0002	CULT 9.06 .003 GEN 11.34 .001		IDV culture more ethical response Female more ethical response	
2	7.02	.0001	CULT 3.74 .053 GEN 14.82 .001		IDV culture more ethical response Female more ethical response	
3	19.57	<.0001	CULT 51.51 .001 GEN 5.90 .015		IDV culture more ethical response Female more ethical response	
4	26.42	<.0001	CULT 69.78 .001 GEN 9.11 .003		IDV culture more ethical response Female more ethical response	
5	82.97	<.0001	CULT 242.02 .001 GEN 6.82 .009		IDV culture more ethical response Female more ethical response	
6	14.91	<.0001	CULT 35.14 .001 GEN 6.86 .009		IDV culture more ethical response Female more ethical response	
7	99.95	<.0001	CULT 299.19 .001		IDV culture more ethical response	
8	141.41	<.0001	CULT 408.37 .001 GEN 15.33 .001		IDV culture more ethical response Female more ethical response	
9 <sup>b</sup>	17.66	<.0001	CULT 45.17 .001 GEN 5.46 .020		COLL culture more ethical response Female more ethical response	
10 <sup>b</sup>	26.27	<.0001	CULT 24.23 .001 GEN 44.58 .001 CULT*GEN 10.00 .002		COLL culture more ethical response Female more ethical response COLL female most ethical; IDV male least ethical; primarily driven by gender	
11	13.67	<.0001	CULT 37.49 .001		IDV culture more ethical response	
12 <sup>b</sup>	33.40	<.0001	CULT 75.42 .001 GEN 21.93 .001		COLL culture more ethical response Female more ethical response	
13	5.79	.0006	CULT 12.86 .001 GEN 4.13 .043		IDV culture more ethical response Female more ethical response	
14	13.36	<.0001	CULT 25.39 .001 CULT*GEN 13.28 .001		IDV culture more ethical response IDV female most ethical COLL female least ethical; primarily driven by culture	

Table 2 - GLM Analysis Results ( $p < .05$ ) (Continued)				
No.	Model F-value	Model p-value	Significant Variables F-value/p-value	Results <sup>a</sup>
15	99.10	<.0001	CULT 285.54 .001 GEN 11.10 .001	IDV culture more ethical response Female more ethical response
16	33.18	<.0001	CULT 95.11 .001 GEN 4.39 .036	IDV culture more ethical response Female more ethical response
17	14.40	<.0001	CULT 33.71 .001 GEN 8.08 .005	IDV culture more ethical response Female more ethical response
18	19.33	<.0001	CULT 44.94 .001 GEN 12.28 .001	IDV culture more ethical response Female more ethical response
19	5.98	.0005	CULT 8.50 .004 GEN 9.42 .002	IDV culture more ethical response Female more ethical response
20	34.51	<.0001	CULT 94.76 .001 GEN 8.11 .005	IDV culture more ethical response Female more ethical response
21	72.02	<.0001	CULT 214.16 .001	IDV culture more ethical response
22	6.07	.0004	CULT 13.03 .001 GEN 4.75 .030	IDV culture more ethical response Female more ethical response
23	16.56	<.0001	CULT 35.74 .001 GEN 13.89 .001	IDV culture more ethical response Female more ethical response
24	18.53	<.0001	CULT 51.09 .001 GEN 4.48 .035	IDV culture more ethical response Female more ethical response
25	34.05	<.0001	CULT 84.95 .001 GEN 6.84 .009 CULT*GEN 10.36 .001	IDV culture more ethical response Female more ethical response IDV female most ethical; COLL female least ethical; primarily driven by culture
26	15.25	<.0001	CULT 32.58 .001 GEN 12.49 .001	IDV culture more ethical response Female more ethical response
<sup>a</sup> IDV - Individualistic; COLL - collectivistic				
<sup>b</sup> Only items 9, 10, and 12 indicated more ethical response by COLL culture				

Two of the three items ranked least unethical also were the same for both cultural groups (See Table 4). At the bottom of the list of unethical behaviors for the IDV group are No. 9

(Studying from someone else's notes), No. 12 (Obtaining an old exam from a previous semester/quarter), and No. 14 (Discussing exam questions with students from earlier sections). The COLL group also ranked Nos. 9 and 14 as least ethical. However, item No. 12 was not among the three least unethical actions, but rather No. 25 (Working in groups when instructed to work independently) was among the three least unethical for the COLL group. Working in groups is highly consistent with the collectivist society but not with the individualistic society. Therefore, it is expected that this action would be considered less unethical in the COLL group than by the IDV group.

<b>Table 3 - Dilemmas Rated Most Unethical* by Culture</b>			
No.	Dilemma	IDV Rank Mean	COLL Rank Mean
24	Having someone take a test for you	1 1.224	3 1.591
26	Interfering with another student's work	2 1.225	2 1.534
22	Changing a test from the original handed in	3 1.295	1 1.474

\* The lower the mean response, the greater the dilemma is judged to be unethical.

<b>Table 4 - Dilemmas Rated Least Unethical* by Culture</b>			
No.	Dilemma	IDV Rank Mean	COLL Rank Mean
9	Studying from someone else's notes	26 3.916	26 4.411
12	Obtaining an old exam from a previous semester/quarter	25 3.404	
14	Discussing exam questions with students from earlier sections	24 2.696	25 3.439
25	Working in groups when instructed to work independently		24 3.202

\* The higher the mean response, the greater the dilemma is judged to be less unethical.

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## **GENder Variable**

The results of the general linear model indicate that female respondents rated the questionable actions as more unethical than did the males on 22 of the 26 items. This result is consistent with previous studies that have found a stronger ethical orientation among females than among males. Significant differences between females and males were found on all items except No. 7 (Obtaining answers from someone during an exam), No. 11 (Taking a test for someone else), No. 14 (Discussing exam questions with students from earlier sections), or No. 21 (Arranging with another student to give or receive answers). Item Nos. 7, 11, and 21 were all rated very unethical by both genders (i.e., means of 1.88, 1.50, and 1.79, respectively), and No. 14 was rated relatively neutral by both genders, with a mean of 3.19.

## **CULT\*GEN Interaction term**

There were 3 items for which a significant interaction effect for culture by gender was indicated. The results of the Duncan's pair-wise comparisons are shown in Table 5. The three significant interaction items are No. 10 (Visiting a professor after an exam, attempting to bias grading), No. 14 (Discussing exam questions with students from earlier sections), and No. 25 (Working in groups when instructed to work independently). On item No. 10, COLL females rate the action as most unethical and IDV males rated it as the least unethical. A significant difference was found between IDV males and COLL males, and a significant difference was found between COLL males and COLL females. The results indicate that the response significance is driven primarily by the gender variable.

On item No. 14, a significant difference was found between COLL males and COLL females and a significant difference between IDV males and IDV females. IDV females rated the action the most unethical, and COLL females rated it as least unethical. The significant difference was driven by the cultural variable, with the IDV culture providing the more ethical response. On item No. 25, the responses of COLL males and females were not significantly different. However, the responses of the COLL males and females were significantly different from those of the IDV males and IDV females. A significant difference also is indicated for IDV males and IDV females. IDV females rate the action as most unethical and COLL females rate it as least unethical. The interaction effect on the No. 25 responses is driven primarily by the cultural variable.

Table 5 - Significant Culture*Gender Items ( $\rho < .05$ )						
No.	Culture/Gender	$\bar{x}$	n	Duncan Grouping*		
10	IDV Male	3.248	198	A		
	COLL Male	2.515	130		B	
	IDV Female	2.355	220		B	C
	COLL Female	2.219	237			C
14	COLL Female	3.536	237	A		
	COLL Male	3.262	130		B	
	IDV Male	3.189	201		B	
	IDV Female	2.767	219			C
25	COLL Female	3.228	237	A		
	COLL Male	3.154	130	A		
	IDV Male	2.720	200		B	
	IDV Female	2.291	213			C

\* Those groups denoted by different letters indicate significant difference. All groups denoted by the same letter are not significantly different from one another.

## DISCUSSION

This study compares the responses of business students from two cultures on a questionnaire that asks students to indicate how unethical they believe the academic actions to be on a list of 26 questionable behaviors. The results of the analysis indicate there are only subtle differences captured by the data on the cultural variable. Although the IDV group rated most of the items as more unethical than did the COLL group, no striking difference was noted in the rank order of the items. That is, the items that were rated as more unethical were more or less the same for both groups. The same can be said for the items rated as less unethical. On the gender variable, the results are consistent with prior studies which have shown a greater ethical sensitivity for females. The results of this study indicate this to be true in both individualistic and collectivist societies.

Two limitations of this study should be noted, both of which may partially explain the more ethical ratings by the IDV group. One limitation relates to the measurement criteria of the research instrument and the other to the measurement scale. The instrument was developed in the US and presumably validated with US students. It is possible that the measurement criteria is not effective

to the same degree in the Asian culture. Further research should be conducted to develop a set of measurement criteria that is reliable across cultures.

The second limitation relates to the use of the five-point Likert scale. Anecdotal evidence suggests that Asian subjects are less willing than US subjects to use the end points of the Likert scale used by the questionnaire. Moreover, the Pearson Product-Moment Correlation, as shown in Table 6, indicates confirmation of the relationship between the response scores by both cultural groups with a correlation of .755 (p-value <.0001). A Spearman Correlation test run on the ranks of the response means indicated similar statistics ( $\rho = .792$ , p-value <.0001). To the degree that is a correct observation, the results of the General Linear Model would be biased. Additional research is needed to determine whether the Likert scale is reliable across cultures.

<b>Table 6 - Pearson Product-Moment Correlation Coefficient</b>	
	<b>COLL Culture</b> $\bar{x} = 2.39188$ S.D. = .64254
<b>IDV Culture</b> $\bar{x} = 1.94908$ S.D = .78259	.7545 <.0001

## ENDNOTES

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<b>APPENDIX - Short Form of Dilemmas Surveyed</b>	
No.	Dilemma
1	Citing someone else's work as your own
2	Failure to report unfavorable grading errors
3	Copying homework and turning it in as your own
4	Using cheat sheets during an exam
5	Not contributing your fair share of a group project
6	Falsifying or fabricating a bibliography
7	Obtaining answers from someone during an exam
8	Giving answers to someone during an exam
9	Studying from someone else's notes
10	Visiting a professor after an exam, attempting to bias grading
11	Taking a test for someone else
12	Obtaining an old exam from a previous semester or quarter
13	Writing a term paper for someone else
14	Discussing exam questions with students from earlier sections
15	Giving answers to someone else during an exam
16	Having someone else write a term paper
17	Giving exam questions to students in later sections of a class
18	Using an exam stolen by someone else
19	Buying a term paper
20	Copying answers off another's exam
21	Arranging with other students to give/receive answers
22	Changing a test paper from the original handed in
23	Making improper use of another's computer file/program
24	Having someone else take a test for you
25	Working in groups when instructed to work independently
26	Interfering with another student's work to the detriment of that student's grade

# **REGULATORY ISSUES**

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## IS SUBCHAPTER S VIABLE FOR COMMUNITY BANKS?

**Charles R. B. Stowe, Sam Houston State University**

**Keith Jenkins, Sam Houston State University**

**James B. Bexley, Sam Houston State University**

### ABSTRACT

*With the economic slowdown, boards of directors and management are pressed to examine strategies to protect shareholder interests. For community banks, the slowdown may not be as severe as in the high tech industries. On the other hand, community banks generally don't have much slack to engage in 'downsizing' either. This paper provides an overview of a strategy which can deliver more shareholder wealth through the legal reduction of taxes by shifting to "S" corporation status. The laws concerning S corporations have been around awhile. The procedure to change the tax status is relatively simple. The issue is relevant for community banks.*

### INTRODUCTION

There are currently over 5,300 community banks that are members of the Independent Community Bankers of America. These member institutions hold more than \$486 billion in insured deposits, \$592 billion in assets, and more than \$355 billion in loans. They employ more than 239,000 people. Approximately 40 percent of these community banks are found in towns with less than 2,500 population. Two thirds of the community banks have less than \$100 million in assets ([www.ibaa.org](http://www.ibaa.org)). While this paper is limited in its application to community banks, it may serve as a useful study for finance or banking majors who need to understand the value of legal and tax analysis for the financial services industry. This paper is also written for the benefit of shareholders of community banks who are looking for fairly conventional ways of reducing taxes without undertaking risky and costly strategies.

### DISTINGUISHING S FROM C CORPORATIONS

Corporation law falls under state law. Each state has enacted some form of the Model Corporations Act which specifies a fairly simple and non-arbitrary process for securing a state charter for a corporation. While some people get confused over the distinction between a C

corporation and an S corporation, the distinction is quite simple. An S corporation is a C corporation that has applied to the Internal Revenue Service for special designation as an S corporation. Otherwise, all the procedures for creating a C corporation and an s corporation are exactly the same. The general requirement being that articles of incorporation must be filed with the Secretary of State along with the required payment of the filing fee. So long as the founders have not taken another institution's name, the promoters are given a corporate charter. It is not necessary to indicate in the articles of incorporation whether the corporation will seek S corporation status. Nor is it necessary to have any different by-laws or internal procedures. Conducting shareholder elections, maintaining corporate books and records, and other corporate formalities are exactly the same for C and S corporations. The specific requirements for maintaining the corporate charter are set by individual state law. The requirements for electing S corporation status fall under federal law.

The S corporation status is defined by the Internal Revenue Code (26 USCS section 1361 (2001)). The S corporation status is available for any corporation which does not have more than 75 shareholders, does not have any shareholders that are not persons which excludes foreign trusts for example, and does not have non-resident alien shareholders. Certain types of corporations may not apply for S treatment. These include financial institutions using the reserve method of accounting for bad debts, insurance companies subject to taxes under section L, and corporations organized as a DISCs (DISCs are C corporations that elect special tax treatment for engaging in international transactions) (26 USCS section 1361 (b)).

As related to community banks, there is another important concept to consider. The S corporation election is regulated only by the International Revenue Service. Generally, there are no other bank regulations by OCC, FDIC, or other regulators restricting or altering the basic requirements and procedures for an S corporation election. Given that banking is one of the most heavily regulated industries in America, the option to seek the S corporation status is not one that requires prior approval from bank regulators, federal or state. It should be noted that if the community bank requires a 'reverse' merger in order to reduce the number of shareholders to below 75, then regulatory approval may be necessary. However, the election of the S corporation status itself does not require regulatory approval by bank regulatory agencies.

Basically, S corporations are C corporations that fit the IRS requirements to elect to avoid double taxation. The S corporation is permitted to avoid corporate income tax by flowing the reporting of earnings directly to the shareholders. Given that corporate tax rates jump to 48% after the first \$50,000, substantial tax savings may occur when the S election is taken. The top rate for individuals is much lower than the corporate tax rates. The issue then is whether community banks should consider the S corporation election?

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## THE S CORPORATION ELECTION FOR COMMUNITY BANKS

The election of S corporation offers community banks the opportunity to save taxes for their shareholders and the possibility of increasing shareholder wealth. It neither improves nor changes the benefits of the corporate form in terms of shareholder limited liability for the debts and obligations of the corporation. Nor does the S corporation election change in any way other shareholder's rights as granted under state law.

The S corporation election results in eliminating federal corporate level taxes on income. The result is that all income generally passes through to shareholders. As previously mentioned, the tax savings can be substantial. If a community bank has one million in pre-tax earnings, their federal corporate income taxes would be \$340,000 leaving a net profit of \$660,000 available for payment to shareholders. Assuming the bank elects to pay out all of their earnings, the shareholders would report those dividends as earnings. Assuming all the shareholders are in the top federal income tax bracket of 40 percent, they would pay collectively some \$264,000 in federal taxes leaving net cash to shareholders of \$396,000. If the community bank was a subchapter S corporation, it would pay no federal corporate income taxes leaving the entire one million dollars available for shareholder distribution. Taking the same assumption that all the shareholders are in the top federal income tax bracket of 40 percent, they would pay collectively \$400,000, leaving the shareholders with \$600,000. The net tax savings would be \$204,000 (Ford). If a bank distributes 100 percent of its earnings as dividends, the overall savings for the bank's shareholders would amount to 34 percent

Obviously, most community banks will retain some of their profits to fund future growth. However, even when banks do not pay out all their profits in dividends, the tax savings are still significant due to the elimination of double taxation and the fact that rates are lower for individuals than for corporations.

If a bank has earnings but the Board of Directors decide not to pay any dividends, the shareholders of an S corporation will have a tax bill. But, they also receive a stepped up basis for the cost of their shares of stock.

In the event that the community bank decides to pay no dividends from their earnings, the shareholders will still have some tax advantage in that they will be permitted to write up the cost basis of their shares. Paying no dividends when the bank has earnings is unlikely to be popular, but the negative impact may be partially offset by the increase in stepped up basis of the cost of their stock in the bank. Of course, this assumes that some capital gains tax will still be levied. Currently the rate is 20% on long term capital gains. So, one may conclude that there is a 10% advantage even when no dividends are paid out assuming that at some point, a shareholder will sell their shares and benefit from the stepped up basis.

If the bank actually posts a loss, then shareholders will be able to reflect their pro rata share of the loss to offset income on their personal income taxes if the chapter S election is taken. However, this condition is likely to be temporary as bank regulators will not have a lot of patience

if the institution does not meet their risk capital requirements and other financial standards to maintain their charter.

So, from a tax standpoint, the selection of the S corporation status offers Community Bank shareholders considerable tax savings. From a fiduciary standpoint, the selection of the subchapter S election is well within the scope of authority of the Board of Directors and while not mandated, is certainly worthy of consideration.

The disadvantages of the election include the following: (1) the expense of making the conversion which mostly consists of legal and accounting costs, and (2) the possible need to take actions to conform to the legal requirements for making the election. For banks that already have less than 75 shareholders with none of them currently LLCs, partnerships, or foreign trusts, the costs may be as low as \$5,000 (Ford).

The real impediment may be that there are some non-qualifying shareholders. The solution to that problem lies in cashing out certain shareholders in order to reduced the total number of shareholders below 75 or to eliminate ineligible shareholders. One way to reduce the number of shareholders is to pass a reverse stock split (which would not change the capital base of the bank), or to conduct a "phantom" merger with a newly created entity. The one real barrier is if the founding family who owns a material percentage of the bank has done some estate planning and placed their stock holdings into a family limited partnership. Such family limited partnerships would prohibit the election of subchapter S treatment and buying out the founding family may not be economically or financially possible. Certainly before a majority interest or founding family considers putting their shares into such an estate planning tool, they should consider the loss of the subchapter S election.

Another possible disadvantage may also be overcome through effective shareholder communication. Some bank directors may fear that such a change in policy might cause alarm or concern in the community or among shareholders. If the financial justification is explained to the community and shareholders in an effective manner, this concern should not negatively effect bank operations. Here is a way that Board of Directors can increase income to shareholders without the negative consequences of downsizing. Particularly in cases where the bank is already paying out dividends, the results can be dramatically illustrated in communications to shareholders.

Some Directors may be reluctant to pursue the S chapter conversion for fear that they will sacrifice flexibility in future financing for the bank. They may reason that reducing the shareholders to 75 or less would mean that the bank would be unable to raise additional capital through the sale to new shareholders. However, the election of S corporation treatment is not a permanent commitment. Recall, that the subchapter S election is not a change in the corporate structure, but merely an application made to the Internal Revenue Service for a change of tax status. Under the Internal Revenue Service Code, an organization may convert back to tax treatment as an S corporation by filing one year in advance of the fiscal year they wish to sell stock. So, becoming an S corporation is not a permanent change of status. A second related issue is that S corporations

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are only permitted to have one class of stock. This eliminates the possibility of raising additional capital through the sale of preferred stock (26 USCS Section 1361 (b) (2001)).

There are two other potential disadvantages to conversion to S corporation status that should be considered. One is that tax laws require banks converting to Subchapter S revalue their assets to fair market value at the time of conversion and then recognize gain on the difference between current valuation and the bank's basis if the asset is sold within 10 years after the conversion. This should not be a problem because banks carry their portfolios at fair market value. The only exception might be the bank's real estate - their building and land (Ford). So, if the bank is considering selling their present land and building, then they should do so before they take the election. Realistically, small community banks do not move their locations very often so this is only a potential concern.

The other concern is has to do with the fact that after conversion the bank would not longer be permitted to use the reserve method of accounting for bad debts. Subchapter S corporations are required to use the so-called 'charge off method' whereby the bank will only be able to make reserve allocations in the specific amounts of actual charge-offs. The negative tax implication is that the bank has to bring its existing reserve back into income for tax purposes in increments over a four year period (Ford). A bank considering the subchapter S election should therefore consider the variance and total tax cost of aligning their reserve. It may well be that most community banks will find that the tax savings will more than offset any increase in earnings from the change in accounting method used to report income even when the reserve balance is restated over a four year period. The charge off method is accepted as a generally accepted accounting principle so that the bank's audited financial statements would not be subject to a qualified opinion in the event of a change to subchapter S status.

## CONCLUSIONS

Meeting the requirements to elect subchapter S treatment is the main barrier to reducing total return for shareholders. The limitations of the number and type of shareholders may make it impossible for a Community Bank's board of directors to elect the conversion. However, there are strategies that may not politically and economically feasible such as reverse stock splits or tender offers for small number of shareholders. The real issue is whether normally conservative and status quo Board members would dare impose a corporate 'tax bill' along with their dividend checks! The reality is that the shareholders who receive dividends are going to report their dividends on their federal income tax form anyway, so if the bank does not distribute 100% of the earnings as dividends, the shareholders will need to understand that they are still ahead of the game as double taxation has been eliminated. Here again, what may appear as a disadvantage can be converted to the bank's advantage. By explaining that the subchapter S election is making more of the bank's

earnings available for distribution, the shareholders are benefiting. And to the extent that the earnings are not distributed, the shareholders are receiving a stepped up basis in the cost of their shares thereby reducing the future capital gains tax (assuming no rise in the rate).

Prior to filing for the election, management time and effort is required to thoroughly investigate whether the entity qualifies for such treatment. And, this should be independently reviewed by the bank's certified public accountants. However, such costs are quite reasonable when compared with the tremendous tax savings for the shareholders. And, should the institution at some later time decide to raise substantial capital for whatever reason, it can reverse the decision with adequate notice to the Internal Revenue Service.

So, while it is impossible to predict how many of the 3,500 or more community banks would qualify for subchapter S treatment, it is certainly worthy of Board time to investigate such a strategy. How often can one offer a strategy that can increase earnings by 10-30% without laying off any people or without reducing any services?

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